

MANUAL ON COMMERCIAL LAW

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NATIONAL EDITION

NEW YORK
PRENTICE-HALL, INC.

1948

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PRINTED IN THE UNITED STATES OF AMERICA

Preface to National Edition

It is hard to practice law actively for a third of a century, and to teach and write on this subject for a large part of this period, without acquiring a profound distaste for such legal clichés as “authorities differ,” “the law is unsettled,” “the cases are in conflict” and “the states are not in accord.”

Authorities *do* differ, the law *is* unsettled, the cases *are* in conflict and the states are *not* in accord; but the student of business and of business law today is in pressing need of a composite picture of what the law *is*, not how it differs. He wants this information, not in terms of general principles, but of specific situations; and so far as possible, he wants these situations interpreted in the light of the law of his own state, rather than that of a state two thousand miles away.

A growing sense of this need has been borne in on the author ever since the first edition of his Manual, based in large part on New York law, first saw the light some fifteen years ago. This feeling was fortified as succeeding editions of the Manual spread across the country and even traveled to Puerto Rico and the Philippines. The feeling finally grew into a decision to abandon entirely any further editions of the original work, and to re-write the Manual *in toto* as a National Edition, with emphasis on uniform principles, and with extensive footnote references to the decisions of our courts throughout the forty-eight states of the Union, so that the reader and student may think in terms of the law of his own state.

It is with this thought, also, that the author has presented the various nationwide tables which appear throughout the book, for example, the table on uniform statutes which appears on pages 12 to 13; the table on the statutes of limitation which appears on pages 45 to 46; summaries such as those which appear in the footnotes on page 80, showing the law in the various states as to the necessity of consideration in contracts under seal; the table on the statutes of frauds governing contracts for the sale of personal property which appears on page 91; the table on legal and lawful rates of interest on ordinary loans, and on small loans, with the penalties for usury in the different states (pages 532 to 534); and the various other

summaries by states which appear either in the text or in footnotes throughout the National Edition. In dealing with negotiable instruments, the stress has been on the Uniform Negotiable Instruments Law. In dealing with sales, frequent reference is made to the rules as laid down by the Uniform Sales Act. The same applies to the discussions on conditional sales (Uniform Conditional Sales Act), warehouse receipts (Uniform Warehouse Receipts Act), bills of lading (Uniform Bills of Lading Act), partnership (Uniform Partnership Act), corporations (Uniform Stock Transfer Act), trust receipts (Uniform Trust Receipts Act), and the apportionment of estate revenues between principal and income (Uniform Principal and Income Act). And to help orient the reader and student to the law of his own state, some one thousand annotations have been supplied in the footnotes, referring to court decisions in the forty-eight states of the Union.

A word as to text treatment.

If there is one thing that the author has learned in his thirty years' experience in teaching commercial law, it is that legal rules may flow swiftly through the mind of reader or student without leaving a trace, but legal *situations* stick, and the legal principles which they entail usually stick along with them. And that, of course, accords with our natural experience in learning anything. The author has endeavored, as far as possible, to present the law as it is presented in real life: problems and situations, and how they were resolved under established rules of law. This, the author is convinced, is far superior, from the educational standpoint, to the orthodox method of presentation, which consists in summarizations of legal rules, with or without supporting citations, examples or cases.

In adopting this form of presentation, the author has found ready to hand a vast storehouse of problems and situations which present superbly a complete panorama of the entire field of commercial law. For the past thirty years or more, experts in their particular field have devoted careful thought and painstaking effort to preparing examination questions for candidates for CPA degrees throughout the United States. These questions touch on almost every conceivable field of commercial law. Regularly, twice a year, examinations in commercial law have been held in the different states through-

out the country as part of the official tests which candidates must pass before they can be admitted to practice as CPAs. The examination questions most widely given are those which are prepared by the experts on behalf of the American Institute of Accountants. These are now given in every state of the Union except Maryland, Ohio, Pennsylvania and Wisconsin. New York State has prepared its own examinations during these years, through its board of certified public accountant examiners, until May 1946, when it joined the other states in adopting the American Institute's questions and problems. These combined American Institute and New York questions and problems in commercial law—some 1600 in number—prepared by these experts represent about every conceivable type of legal situation that is likely to arise in the course of business experience. The author, before writing a line of text, examined and closely analyzed each of these questions and problems; and the text presented in the National Edition has, in a very real sense, grown out of these questions and problems, instead of *vice versa*. If, as the author earnestly hopes, this form of presentation imparts a flavor of realism to the text, the credit is not the author's, but rightly goes to the examining boards and their experts who formulated so rich an array of concrete problems reflecting those which are commonly met with in daily business experience. I take this occasion to salute the authors of these questions and problems and to extend thanks to the American Institute of Accountants and to the New York Board of CPA Examiners for the privilege of using these questions and problems in the preparation of the National Edition.

Space will not permit mention of the author's numerous friends, including judges, lawyers, and educators, who have contributed valuable suggestions to this work. For the assistance thus given, the author is deeply grateful. The author is especially grateful for the assistance rendered by his staff, particularly the conscientious effort of Rita Sbuttoni in checking the numerous and exacting details which go into a work of this character.

THE AUTHOR

March 31, 1948

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Part I

SUMMARY OF COMMERCIAL LAW

The Questions and Problems for Review which appear at the end of each chapter, together with the General Review questions and problems which are given at the end of Part I and the questions and problems which are given in Part II, are reproduced exactly as given by the American Institute of Accountants and by the New York Board of CPA Examiners. The letters "AI" refer to the American Institute questions and the letters "NY" to the New York questions. Thus:

AI May 1924 (11) refers to the 11th question prepared by the American Institute of Accountants for the May 1924 examination.

NY Apr. 1934 (8) refers to the 8th question prepared by the New York Board for the April 1934 examination.

CHAPTER I

Law in General

1. **Scope of this chapter.** In this chapter we shall consider the nature, origin and kinds of law; the substance of the law, including rights, wrongs and duties; governmental powers for enforcing the law, including the basic constitutional rights, powers, privileges and limitations; and procedure, or the manner in which rights and duties are enforced and wrongs redressed.

A. Nature, Origin and Kinds of Law

2. **Nature and definition of law.** Law is rule; such as a rule of action (*laws of physics, chemistry, economics*) or of conduct (*moral law, divine law, municipal law, international law*).

Municipal law deals with rules of conduct governing persons within a sovereign state, as distinguished from *international law* which deals with the conduct of nations and their respective peoples in their intercourse with one another. Municipal law is defined by Blackstone as "a rule of civil conduct prescribed by the supreme power in a state, commanding what is right, and forbidding what is wrong." The word "municipal" in this sense is derived from the Roman "municipium," and is intended to convey the idea of a complete, self-sustained governmental unit.

The law of the land is an expression commonly used to indicate the rules of human conduct by which a civilized community hears before it condemns, proceeds upon inquiry, and renders judgment only after trial, thereby safeguarding each person's life, liberty and property.

3. **Substantive and adjective law.** *Substantive* law tells us what our rights and duties are and what constitutes a violation of such rights and duties; *adjective* law tells us how we may enforce our rights and duties and redress our wrongs. If you and I enter into an oral agreement by which I am to render

services and you are to pay me \$500, the question of whether such an agreement is enforceable is one of substantive law. If we assume that I could enforce such an agreement, the question of how I should go about enforcing it—how one brings the matter to suit, trial and judgment—would be a question of adjective law.

4. Origin and evolution of law. In the history of law, we perceive a common tendency. First we have custom, usage and tradition, reflecting an existing state of morality, followed by an effort to codify and crystallize the accumulated mass of custom and usage into codes or statutes.

This is illustrated by the ancient Hebrew law, which reflected current custom, was crystallized into The Ten Commandments, and was subsequently amplified in the Talmud.

The same tendency characterized the development of law in the civilized states of Greece: first we have custom and precedent established by centuries of habit and tradition growing out of the ancient Greek concepts of morality and religion—habits of life imposed by belief in a hierarchy of virtues and vices embodied in mythical gods—followed by efforts to codify these rules of life and to give them permanence in written form. It was largely from this source that the Romans, great law givers, derived their Twelve Tables.

As times changed, customs changed, and these in turn gave rise to new codes. By the time of the Roman Emperor Justinian, the laws had become so voluminous and unwieldy that it became necessary to condense and digest them into a new code, known as *Corpus Juris Civilis* which, translated into Greek and transformed into yet another code, under the title of *Basilicae*, retained its force in the Eastern Empire until the conquest of Constantinople by the Turks.

In the Western Empire, the laws of Justinian were lost during the dark ages, but about the year 1137 a complete copy of them was found, whereupon they were revived, and formed the basis of jurisprudence for the major part of the continent of Europe. Hence, the present law on the continent of Europe is referred to as the *Roman* or *Civil* law.

English law, derived from Anglo-Saxon custom and from the customs and traditions of the Normans, who invaded and conquered England, developed quite apart from the Roman or

Civil law; but it has reflected the same tendency to crystallize custom-law or precedent-law into codified form.

5. **Unwritten law.** Law based on precedent alone is commonly referred to as *unwritten law*. Originally formulated by rulers, prophets and priests, it now takes the form of judicial decisions.

Actually, what we call "unwritten" law is today not only written, but printed and published, so that all may consult it. But in less enlightened times, unwritten law was in very truth unwritten. This was particularly so in the dark ages, when justice was administered by appeal to the supernatural. Examples were trial by combat and trial by ordeal. In the former, a trial consisted of physical combat between two litigants, and the verdict went to the strongest lance or the mightiest club; in the latter, guilt or innocence was determined by holding a hot iron with the bare hands (whoever dropped it first was guilty); or, as in the case of witchcraft, by the simple test of ducking the accused in a body of water: if she came out dead, she was innocent, and if she came out alive, she was guilty and burned at the stake.

When, however, reason began to dawn in the administration of justice, and some royal judge, in trying an issue between two litigants, pronounced a principle applicable to the facts and founded in logic, common sense, or a sense of fair play, a true legal precedent was established, to be followed subsequently if the same set of facts transpired.

As these precedents or legal principles grew, they furnished a pattern of unwritten law, inscribed at first only in the memories of judges and lawyers, and either recalled from personal experience, or transmitted by word of mouth.

Mere memory, however, became insufficient, and notes of these cases and legal principles found their way into the memoirs and private records of bench and bar. Some of these notes were compiled and published in the form of commentaries, such as those of Coke, Lyttleton, Blackstone and—in our own country—Kent. By means of these commentaries, together with various digests, Year Books, and so forth, the "unwritten" law took on more definite and coherent shape.

Not only were these precedents thus clarified and given permanence, but they came to be reported and published by

official reporters from the transcribed opinions of the judges. Today they are to be found on our law shelves in the form of volumes published, bound and numbered in sequence, so that they may easily be referred to by volume number and page as a source of law and a guide for determining the application of legal principles to a given set of facts.

Unwritten law embraces four subdivisions:

- (a) Common law.
- (b) Equity.
- (c) International law.
- (d) The Law Merchant.

6. Common law. Common law is the earliest branch of unwritten law founded on ancient English usage and custom. As reflected in judicial decisions, modified to suit the changing needs of changing times, and adapted to our own needs and institutions, it continues to serve as a fundamental branch of our law. Its keystone is *stare decisis*: the doctrine that constrains judges to stand by former decisions as far as possible, without following too slavishly the outworn dogma of the past.

7. Common law courts and common law actions. A court in which a common law remedy is sought is known as a *common law court*, or *court of law*, and the action in which such remedy is sought is known as a *common law action*, or, more briefly, a *law action*. The jurisdiction of a court of law extends to those matters which were originally recognized only at common law. Ordinary law actions have for their object the assessment of damages. For example, the ordinary breach of contract action is a law action in which a party sues for money damages. The same applies to tort actions (sec. 29), such as actions for assault and battery, libel, slander, negligence, conversion, réplevin, and so on.

8. Equity. Equity is that branch of unwritten law, founded in justice and fair dealing, which seeks to supply a more adequate remedy than that available at (common) law. Ordinary law actions, as stated, have for their object the assessment of damages for wrongs done, but a court of equity reaches beyond mere damages: It seeks to prevent the wrong itself, or, if it has already been committed, to requite it more fully than would be possible by a mere payment of money damages. Among the more common equity actions, which provide remedies not available "at law," are the following:

Injunction suits (the most common remedy obtainable only in equity), wherein the court is asked to restrain a person from doing or continuing to do something that threatens or causes irreparable injury;

Specific performance, wherein a party seeks to compel actual performance of a contract, instead of seeking money damages for the breach;

Partition suits, wherein two or more persons own an undivided interest in lands and seek to have separate interests apportioned among them;

"Bills of peace," wherein it is sought to unite several controversies between the same parties to avoid a multiplicity of suits (as where a series of suits are threatened) all founded on the same facts and the same questions of law, so that the decision of one will determine all;

Reformation, wherein a bill in equity is brought to reform a contract so that it will express correctly the true intent of the parties;

Rescission, wherein a court is asked to annul a contract entered into through fraud or excusable error; and

Actions involving a trust, wherein one person has legal title to property which equitably belongs to another.

9. Maxims of equity. In the course of its development since the early days of English chancery, equity has established certain fundamental principles, or maxims, among which are the following:

He who seeks equity must do equity. One who seeks equitable relief must do what is equitable as a condition for that relief. If I seek the return of a chattel which I was induced to sell through fraud, I must tender back the purchase price. If an infant buys an expensive watch and then decides he wants his money back, he must tender back the watch.

He who comes into equity must come with clean hands. One cannot obtain the aid of a court of equity in respect to any transaction, if his conduct in such transaction has been in any way unconscionable, inequitable or offensive to the dictates of natural justice. If, for example, I persuade you to breach a contract to buy Smith's home, and to buy mine instead, and then you breach my contract, too, I cannot seek the aid of a court of equity to compel specific performance of your contract with me.

Equity aids the vigilant, not those who slumber on their rights. This maxim is akin to the doctrine of *laches* (sec. 102) that, if a person sleeps on his rights, his continued silence indicates acquiescence. The maxim is designed to promote diligence, punish laches, and discourage stale claims.

Equity acts specifically. This is applicable to suits for specific performance (sec. 242). It expresses the fundamental distinction between legal and equitable remedies, that in equity you get the precise thing to which you are entitled, whereas in law you get damages instead.

Equity acts in personam. This means that equity compels a person to do what he should do, instead of penalizing him for not having done it, as in the case of a common law judgment affecting his property. Thus, if a court of equity has jurisdiction of a trustee personally, but the property

of the trust is outside the court's jurisdiction, the court may order the trustee to account for or dispose of such property, and for a failure to obey, may punish the trustee for contempt of court.

Equity follows the law. Except where the common law is clearly inadequate, equity follows the rules and precedents of the common law and the provisions of a governing statute. If a deed or other instrument is void at law, or by statute, the mere fact that an innocent holder has given value for it will not render it valid in equity.

Equity delights to do justice, and not by halves. Once equity acquires jurisdiction, it will retain it so as to afford complete relief. For example, if suit is brought for reformation (sec. 8) of a contract, the court, if the facts warrant, will not only reform the contract but will compel its observance as reformed.

Equity will not suffer a wrong without a remedy. Unlike remedies at law, which are fixed and rigid, remedies in equity are flexible and are designed to tolerate no situation where one has a right without a remedy. Subject to statutory limitations, equity has jurisdiction "in the whole domain of conscience." It can mold its remedies to meet any conditions. It is not dependent on precedent alone: If a party has a right which should be enforced in equity but no precedent for a remedy, equity will invent a remedy to protect the right.

Equity regards that as done which ought to be done. Where necessary to promote justice, equity will treat an uncompleted bargain as if it were already completed. For example, under a land contract calling for delivery of title in the future, equity may regard the purchaser as having acquired the property, and the seller as owner of the purchase price.

Equity regards substance rather than form. Common law is normally governed by legal form. Corporations, for example, are regarded in law as artificial beings, separate and distinct from their stockholders, directors, officers and employees. Equity, however, where necessary to circumvent fraud, to protect the rights of third parties and to accomplish justice, may disregard the corporate fiction and penetrate to the substance of the dispute. (See sec. 870, ex. (2).)

Equity imputes an intent to fulfill an obligation. This means, in the language of a leading authority¹ that wherever a duty rests on an individual, "it shall be presumed that he intended to do right, rather than wrong; to act conscientiously, rather than with bad faith; to perform his duty, rather than to violate it." Thus, in *Lee v. Foushee*, 91 Ark. 468, a party and his mother intended to sign a deed, but upon advice of counsel that the son had no title, the mother alone signed. Later the son, upon learning that he had title, sought the aid of equity to regain possession of the land. The court, in denying relief, ruled that it would impute an intention by the son to sign the deed as originally contemplated.

Equality is equity. In the absence of special circumstances requiring a different result, equity will treat all members of a class as on an equal foot-

¹ Pomeroy, Eq. Jur., sec. 420.

ing and will distribute benefits among them equally, or in proportion to their respective interests.

Example: Ten persons own a building. Unable to get along, they sue for partition (sec. 8). The building is sold; the clerk deposits half the proceeds in one bank and the other half in another which later fails. All ten owners would share equally in the funds of the solvent bank, as well as any dividends from the insolvent bank.

Between equal equities, the law will prevail. If two parties have an equal claim in equity, and one of them also has a claim recognized at law, the latter will prevail.

Example: I sell a house to Jones, who fails to record his deed (sec. 1051). I then sell the house again to Smith, who is innocent of the prior sale, pays value for the house, and promptly records his deed (thereby acquiring recognition as the legal owner). If Jones, the prior purchaser, sought to have Smith reconvey title, the court would declare that both parties having equal equities, the law (Smith's legal title) would prevail.

Between equal equities, the first in order of time shall prevail. If various persons acquire liens against property (sec. 1128), the one who acquired the lien first (other things being equal) has first claim upon the property.

10. Marshaling assets. One of the well-known rules of equity is that which relates to the marshaling of a debtor's assets where there are several classes of creditors. Where one claimant has two funds to which he may resort to satisfy his claim and another claimant has an interest in only one of the funds, equity may compel the first creditor to collect out of the fund in which the second creditor has no lien, so that both creditors may be paid. If the first creditor acted as a dog in the manger and exhausted the fund in which the other creditor also had a lien, the latter would have nothing and the former, everything. (See sec. 1356.)

Example: Smith has two parcels of land. I hold a first mortgage on both parcels; you hold a second mortgage (subject to my first) on one of them. If I foreclosed on both parcels, I might wipe your mortgage out. The first parcel, on which you hold no mortgage, is worth more than enough to pay me off. A court of equity, marshaling those assets, might force me to foreclose on the parcel covered by my mortgage only, and thus would leave your security intact.

The rule of marshaling assets is commonly applied in distributing assets among creditors upon dissolution of a partnership (sec. 708) and in apportioning rights among several mortgagees (sec. 1158).

11. International law. International law consists of a body of usage and custom arising out of the intercourse of nations

and their peoples with one another, reinforced by treaties, the writings of jurists, international conferences and the declarations, resolutions and decisions of international tribunals.

(a) *Public international law* regulates the conduct of sovereign nations toward one another.

(b) *Private international law* governs the rights of citizens that may be acquired in one country and enforced in another by virtue of a doctrine of international reciprocity known as the *comity of nations*. Private international law is sometimes referred to as *Application of Foreign Law*, or *Conflict of Laws*. It applies not only internationally, but also among the several states of the Union. (See sec. 197.)

12. The law merchant. The law merchant is that branch of the unwritten law which was originally founded on the customs of merchants, mariners and business men generally in their dealings with one another throughout the civilized countries of the world. In the course of time they were recognized and adopted by the common law, and ultimately embodied in statutes such as the Negotiable Instruments Law. Further reference to the law merchant appears in the chapter "Negotiable Instruments" (sec. 258).

13. Constitutions. A constitution is the basic law of the land, to which all other law must conform. Under our system of dual sovereignty (sec. 50), each state is sovereign except as to powers delegated to the Federal Government; and each state has a constitution of its own. Hence, the laws of each state must conform not only to the United States Constitution, but to the constitution of that particular state as well. The subject of constitutionality is more fully discussed in this chapter under the heading "Governmental Powers" (secs. 50 to 70).

14. Treaties. Treaties are solemn contracts or "compacts" between or among two or more nations. Once adopted, they constitute international law so far as concerns the signatory nations and their respective citizens. Treaties between two countries are *bilateral*; among more than two countries, *multilateral*. The Constitution of the United States provides that treaties may be concluded only by the President with the approval of two thirds of the Senate.

15. Statutes. A statute is a formal enactment by a legislative body of some rule or rules of civil conduct. It is referred to as an *act* when adopted by Congress, a *statute* when adopted by a state and an *ordinance* when adopted by a municipal leg-

islative body, such as a board of aldermen or common council. Statutes are *enabling*, if they grant power; *enlarging*, if they extend power; *restraining*, if they limit power; *disabling*, if they take power away or extinguish it; *corrective*, if they remove or correct hardships in existing law; or *declaratory*, if they declare the common law. Many statutes are substantially declarations in codified form of the previous common law on the subject (sec. 4).

Statutory law is a term sometimes used to indicate that the law on a given subject is based on statute rather than on common law.

16. Uniform statutes. Confusion caused by conflicting judicial decisions and statutes has led to the adoption of uniform statutes in various states throughout the country. The matters involved being of state, not Federal, jurisdiction, co-operative state action was necessary to insure uniformity. Model statutes formulated under the direction of a committee of the American Bar Association have been adopted in numerous states, and thereby insure uniformity of legislation on the subject among the adopting states. More than sixty such statutes have been adopted by various states. The more important ones are shown in the table on pages 12-13, with the adopting states and the year of adoption.

17. Business or commercial law. In recent years the terms *business law* and *commercial law* have come into general use to denote rules of law of primary concern to business and to the professions ministering to business. The study of commercial law normally excludes adjective law (sec. 3) and such non-commercial matters as international law, matrimonial rights and duties, and crimes or torts which have no relation to business.

B. Substance of the Law

18. Rights and duties. Every person is a "bundle of rights and duties." These are *reciprocal*: that is, your rights as to me are my duties toward you, and *vice-versa*. Rights are either *natural* or *conventional*, also known, respectively, as *absolute* or *relative*. Natural or absolute rights are those supposed to spring from the nature of our existence. They embrace *personal security*, *personal liberty* and *property*. Conventional or relative rights are those created by "convention"—literally, the *coming together* of individuals upon a united

UNIFORM STATUTES

Showing eight of the more important statutes formulated under the direction of a Committee on Uniform Legislation of the American Bar Association, with years of adoption by the states where they are now in force.

State	Uniform Negotiable Instruments Act	Uniform Sales Act	Uniform Conditional Sales Act	Uniform Partnership Act	Uniform Limited Partnership Act	Uniform Bills of Lading Act	Uniform Warehouse Receipts Act	Uniform Stock Transfer Act
Alabama.....	1908	1931	—	—	—	1931	1915	1931
Arizona.....	1901	1907	1920	—	1943	1921	1921	1943
Arkansas.....	1913	1941	—	1941	—	1941	1915	1923
California.....	1917	1931	—	1929	1929	1919	1909	1931
Colorado.....	1897	1942	—	1931	1931	—	1911	1927
Connecticut.....	1897	1907	—	—	—	1911	1907	1917
Delaware.....	1912	1933	1919	—	—	1927	1917	1945
District of Columbia.....	1899	1937	—	—	—	—	1910	1945
Florida.....	1897	—	—	—	1943	—	1917	1943
Georgia.....	1924	—	—	—	—	—	1938	1939
Idaho.....	1903	1920	—	1920	1920	1915	1915	1928
Illinois.....	1907	1915	—	1917	1917	1927	1907	1917
Indiana.....	1913	1929	1935	—	—	1943	1921	1923
Iowa.....	1902	1919	—	—	1924	1911	1907	—
Kansas.....	1905	—	—	—	—	—	1909	—
Kentucky.....	1904	1928	—	—	—	—	1938	1944
Louisiana.....	1904	—	—	—	—	1912	1909	1911
Maine.....	1917	1923	—	—	—	1917	1917	1943
Maryland.....	1898	1910	—	1916	1918	1910	1910	1910
Massachusetts.....	1899	1909	—	1923	1924	1910	1907	1910
Michigan.....	1905	1913	—	1917	1931	1911	1909	1913
Minnesota.....	1913	1917	—	1921	1919	1917	1914	1933
Mississippi.....	1916	—	—	—	—	—	1920	1946

UNIFORM STATUTES (Continued)

State	Uniform Negotiable Instruments Act	Uniform Sales Act	Uniform Conditional Sales Act	Uniform Partnership Act	Uniform Limited Partnership Act	Uniform Bills of Lading Act	Uniform Warehouse Receipts Act	Uniform Stock Transfer Act
Missouri..	1905	—	—	—	—	1917	1911	1943
Montana.....	1903	—	—	—	—	—	1917	1943
Nebraska.....	1905	1921	—	1943	1939	—	1909	1941
Nevada.....	1907	1915	—	1931	1931	1923	1913	1945
New Hampshire.....	1910	1923	—	—	1937	1917	1941	1937
New Jersey.....	1902	1907	1945	1919	1919	1913	1907	1916
New Mexico.....	1907	—	1919	—	—	—	1909	1943
New York.....	1897	1911	1922	1919	1922	1911	1907	1913
North Carolina.....	1899	—	—	1941	1941	1919	1917	1941
North Dakota.....	1899	1917	—	—	—	—	1917	1943
Ohio.....	1903	1909	—	—	—	1912	1909	1911
Oklahoma.....	1909	—	—	—	—	—	1915	1945
Oregon.....	1899	1919	—	1939	—	—	1914	1935
Pennsylvania.....	1901	1916	1925	1915	1917	1912	1910	1912
* Rhode Island.....	1899	1908	—	—	1930	1914	1908	1912
South Carolina.....	1914	—	—	—	—	1930	1945	1945
South Dakota.....	1913	1921	1919	1923	1925	—	1913	1921
Tennessee.....	1899	1919	—	1917	1920	—	1909	1925
Texas.....	1919	—	—	—	—	—	1919	1943
Utah.....	1899	1917	—	1921	1921	—	1911	1927
Vermont.....	1913	1921	—	1941	1941	1915	1913	1947
Virginia.....	1898	—	—	1918	1918	—	1908	1924
Washington.....	1899	1926	—	1945	—	1915	1913	1939
West Virginia.....	1908	—	1925	—	—	1945	1917	1931
Wisconsin.....	1899	1912	1919	1915	1919	1917	1909	1913
Wyoming.....	1905	1917	—	1917	—	—	1917	1945

purpose; for example, rights arising out of the so-called *domestic relations*, and rights created by *contract*.

19. Personal security. Personal security consists in the peaceable enjoyment of life, limb, body, health and reputation. It may be violated both criminally, as in homicide, arson, robbery, burglary, forgery and larceny (sec. 41); and civilly, as in negligence, assault and battery, libel, slander and malicious prosecution (sec. 29).

20. Personal liberty. Under our system of government, no man, save by express law, can be restrained of his liberty, prevented from going where he pleases, compelled to go where he does not want to, or be in any way imprisoned or confined. If an offender is apprehended, he must be given an immediate hearing before the proper magistrate. Only if reasonable probability of guilt appears may the offender be committed to prison and held for trial. Even then, pending trial, the offender (except in capital cases) may secure his liberty on *bail*, by the posting of a bond for appearance to stand trial. Safeguarding the right of personal liberty is the writ of *habeas corpus* (literally, "have with you the body"): a court order available at all times, requiring one having custody of another's person to produce him on short notice for inquiry into the cause of detention.

21. Property. The legal institution known as *property*, namely, the relationship of persons to things which gives persons exclusive control over things, is guaranteed by the United States Constitution, which provides that no person may be deprived of his property, even for a public purpose, save by due process of law and upon just compensation. The subject of property is dealt with in Chapter XI.

22. Domestic relations. The so-called "domestic relations" include those of *husband and wife*, *parent and child*, *guardian and ward*, and *master and servant*. For the most part, they deal with matters outside the domain of commercial law (sec. 17). A brief reference to these relationships, however, will be useful, since at times they concern certain phases of business law.

23. Husband and wife. Under the common law husband and wife were one, and he was the "one." The wife had no right to contract, nor to own or dispose of property. Most states have removed these common law disabilities. Married

women may now freely and in their own name make all manner of contracts and acquire, own, sell, mortgage, control, devise and bequeath their entire estate, real and personal. Still surviving in most states, are the following rights and duties:

1. The husband has the duty of support: the wife is by law her husband's agent in purchasing for herself and household, necessities as gauged by the husband's income.

2. Husband and wife have an interest in each other's property upon death.

3. A husband has the right to his wife's earnings under the same roof, on the theory that the husband is entitled to his wife's domestic services; and on same theory, if the wife is injured through another's negligence, the husband (apart from the wife's own suit) may sue the defendant for "loss of services."

24. Parent and child. A parent is *natural guardian* of his children. As such he may control and regulate their *persons*, but not their *property*. However, as he is liable for their support until their majority, so he may until then collect their earnings unless they have been "emancipated" (thrown on their own resources).²

Age and status of infancy. An *infant* or *minor* is a person of either sex who has not attained the age of *majority* which marks the status of an adult. The age of majority varies in different states. At common law, and by statute in most states, the age is twenty-one years.³ By common law precedent, which ignores a fraction of a day, an infant reaches the legal age of twenty-one the day before his twenty-first birthday. In some states, the female age of majority, at least for some purposes, has been fixed at eighteen. State statutes vary as to privileges accorded to infants at varying ages, including those in relation to contracts, wills, marriage, voting, and so on. Infants of sufficient age to understand the nature of their acts are liable for their torts and crimes; and in the purchase of necessities, for their contracts (secs. 29, 31, 136).

25. Guardian and ward. Besides the natural guardianship of parents, other forms of guardianship include:

1. *Legal guardian.* If an infant has property, the court appoints a legal guardian (usually, but not necessarily, the parent). The legal guardian must give bond for faithful management, must keep true accounts and file periodic reports with the court, must conform to law as to proper depositaries of funds and proper forms of investment, must not sell or mortgage the ward's real property without court order, and must reasonably safeguard the ward's property on pain of treble damages for improvident losses.

² *Riley v. Holmer*, 100 Fla. 938, 131 So. 330.

³ *Hutchison v. Till*, 212 Ala. 64, 101 So. 676.

2. *Testamentary guardian.* In most states a father and in some states a mother may by will appoint a guardian for a minor child, such guardianship extending to both person and property of the ward until the latter's majority.

3. *Guardian by deed.* A guardian by deed is similar to a testamentary guardian except that appointment is by deed instead of by will. Statutory provisions in some states, copying an early English statute, permit a father to appoint a guardian, by deed, for his infant child, until the latter attains full age.

4. *Special guardian.* A special guardian is one named by the court (usually an attorney at law) to protect the rights of an infant concerned in probate proceedings or having an interest in a decedent estate.

5. *Guardian ad litem.* An infant may not sue or be sued in his own name. If court action is desired by or against an infant, a guardian *ad litem* or "guardian to the action" must first be designated by the court to sue or defend on behalf of the infant.

26. **Master and servant.** The relationship of master and servant was originally domestic, because upon "indenture" of the servant or apprentice to a master, the latter was made to stand in the place of the parent. This domestic relationship has been almost completely superseded by the contractual relationship of employer and employee (secs. 603 to 615).

27. **Wrongs.** A wrong is the violation of some right or duty. Wrongs are either *civil* or *criminal*, although the same act may constitute both a civil and criminal wrong; for example, injuring a person by assault and battery, or by reckless driving.

28. **Civil wrongs.** Civil wrongs invade private rights and duties, hence concern individuals privately rather than the public as a whole. Such wrongs are therefore redressed by private actions, as in *Johnson v. Baker* or *Carr v. Rhodes*, wherein the remedy sought may be at common law for damages or in equity for other forms of redress. Among the more common civil wrongs are *torts* and *breaches of contract*. The latter are discussed in the chapter "Contracts."

29. **Torts.** A tort is the violation of a *natural* right. Examples are:

Negligence, which violates the right of *personal security* or of *property*, by want of reasonable care;

Assault and battery, which violates the right of *personal security* by physical attack upon one's person;

False imprisonment, which violates the right of *personal liberty*;

Conversion, which violates the right of *property* by wrongfully taking or

withholding possession of another's chattel, an action to recover such chattel being known as an action in *replevin*;

Trespass, which violates the right of *property* by unlawful entry upon or interference with possession of another's real property;

Defamation, which violates the right of personal security ("fair name") by the written or printed word (*libel*) or the spoken word (*slander*);

Malicious mischief, which violates the right of *property* by wilful destruction; and

Malicious prosecution, which violates the right of *personal security* by causing criminal proceedings to be brought against another, with malice and without probable cause.

30. Business torts. Certain wrongful trade practices, actionable at law, have come to be designated as *business torts*. Among them are the following:

Unfair or malicious competition; disparagement. If a person enters a business, not as a business competitor, but for the sole purpose of maliciously destroying a competitor, he commits an actionable wrong.

Businessmen may be restrained from making disparaging remarks about a competitor's product, as when a manufacturer carries on a campaign of disparagement by having his salesmen make false statements about the efficacy of a competitor's product.⁴

Threats or intimidation: unlawful picketing. Organized threats against a business are unlawful, except in support of legitimate claims and by legitimate means. For example, a person believing himself to be the rightful owner of a patent may warn a prospective infringer not to infringe, on pain of legal proceedings. On the other hand, if an anti-vice society warns book and magazine distributors that if they sell a certain periodical the society will have them prosecuted and as a result the periodical loses business, the society will be enjoined from continuing such threats. Picketing is lawful so long as it is conducted peacefully in a genuine labor dispute; but when no real labor dispute is involved, or where the picketing amounts to intimidation, as by molesting customers, parading around in a circle in front of the entrance, lying on the sidewalk or otherwise obstructing the entrance, the picketing amounts to intimidation or molestation and is unlawful.

Tortious interference with contracts. The law imposes a duty not to interfere with the contracts of others. One who maliciously induces a party to breach his contract with another, to the latter's injury, may be held for resulting damages.

31. Crimes. Crimes invade public rights and duties and hence are prosecuted by the people. Crimes are either *felonies* (major criminal offenses) or *misdemeanors* (minor offenses). In general, felonies are crimes punishable by death,

⁴ *H. E. Allen Mfg. Co. v. Smith*, 224 App. Div. 187, 229 N.Y. Supp. 692.

or by imprisonment in the state penitentiary. Indictable offenses not amounting to felonies are misdemeanors.

32. Criminal intent. Intent is a necessary element of some crimes; other acts may be made criminal regardless of intent. A person cannot commit murder unintentionally, but his act may be so reckless of life as to constitute manslaughter. On the other hand, purely accidental killing, as in the case of a golfer killed by a ball, would not be classed as criminal.

33. Parties to crime; compounding felonies. The parties to a crime are a *principal*, or one who either directly commits the crime or aids, abets, counsels or procures its commission; and an *accessory*, or one who hinders apprehension of a criminal by concealing him or helping him to escape. *Compounding felonies* or other crimes consists in taking money or reward on an engagement, express or implied, to conceal a crime, withhold evidence or discontinue or delay prosecution; except where compromise is allowed by law.

Forgiveness by employer: when may constitute compounding felony. An employer may forgive an employee's theft, allow restitution, and give him another chance; but if the employer makes restitution part of a bargain for not prosecuting, he is guilty of compounding the offense.

34. Common law crimes. Common law crimes, originally, were those proscribed by precedent only. They were punishable mostly by death. As late as the seventeenth century, there were seven common law felonies in England: homicide, rape, burglary, arson, robbery, theft and mayhem. Except for mayhem and petty larceny (stealing something worth less than twelvepence), these were capital offenses. Though now embodied in penal statutes, these crimes are still referred to as the *common law crimes*. All others are *statutory crimes*.

35. Statutory crimes. Strictly speaking, practically all crimes are now statutory, in the sense that they are defined by statute. Some states have specifically abrogated the common law with respect to crime and have substituted criminal codes, usually with the provision that no act or omission shall be deemed criminal or punishable except as prescribed by statute.

36. Federal crimes. The Constitution of the United States gives Congress power to provide laws and procedure for the punishment of counterfeiting, piracies and felonies on the high seas, offenses against the Law of Nations and infractions of rules and regulations prescribed for the land and naval forces

of the United States. Accordingly, Congress has passed many laws prescribing penalties for acts or omissions in these matters, and these have been compiled into the Criminal Code of the United States.

37. Crimes generally; state penal codes. For all crimes not subject to Federal jurisdiction, state sovereignty is exclusive. Penal statutes of the different states, commonly known as *penal codes*, define and prescribe penalties for a multitude of criminal acts.

38. Criminal jurisdiction; extradition. Crimes must be prosecuted in the place where they are committed. No state can punish for a crime unless it was committed in that state. If a criminal flees the jurisdiction, it is customary, though not compulsory, for the state or foreign country where the criminal is apprehended to surrender the fugitive to the jurisdiction where the crime was committed. This procedure is known as *extradition*.

Inside the state, the county where the crime is committed is the county where the criminal must be tried, unless it can be shown that justice requires trial in another county, in which case a *change of venue* may be directed.

39. Major classifications of crime. Crimes may be against the state and against individuals. In either case, they are offenses against the people.

40. Crimes against the state. Crimes against the state include *treason*, *bribery* and *perjury*.

Treason against the United States, as defined in the Constitution, consists in "levying war against them, or in adhering to their enemies, giving them aid and comfort." There may also be treason against a state.

Bribery is giving, offering, receiving or asking a reward as inducement to influence official action.

Perjury is false swearing wherever an oath is required or allowed by law.

41. Crimes against individuals. Crimes against individuals are numerous and varied. Among the major ones are:

Homicide: the killing of one human being by another, by direct act, procurement or omission. Homicide may be justifiable, as in self-defense. *Murder in the first degree*, punishable by death except where capital punishment is abolished, is deliberate and premeditated homicide.

Arson: unlawfully setting fire to property. *Arson in the first degree* is unlawfully setting on fire, in the nighttime, a dwelling house, car, vessel or vehicle containing a human being.

Robbery: unlawfully taking personal property by force.

Burglary: breaking and entering into the premises of another with intent to commit some crime.

Forgery: falsely making, counterfeiting, altering or erasing an instrument in whole or in part. Forgery may be in the first degree, second degree, third degree, and so on.

Larceny: taking and carrying away another's personal property with intent to appropriate it. Larceny committed by one who lawfully has possession of personal property and wrongfully misappropriates it, is known as *embezzlement*.

42. Frauds and cheats. State legislatures have been zealous in passing laws designed to curb and punish all forms of frauds and cheats, including, among others, the following:

Fictitious partnership names. A person who transacts business by using the name, as partner, of one not interested as such, or by using the designation "and company" or "& Co." when no actual partner is represented thereby is, in many states, guilty of a misdemeanor. (See secs. 654-655.)

Frauds on hotel keepers, by obtaining credit or accommodations through false pretenses.

Circulating false rumors about the market price of stocks, bonds, and so on.

Fraudulently obtaining employment by false letters of recommendation.

False representation or advertisements of employment opportunities by way of inducement to persons seeking employment.

Selling tickets for balls and entertainments without authority from the institution or organization concerned.

Transactions affecting securities, such as reporting or publishing fictitious transactions, false statements or advertisements, manipulation of prices, trading by brokers against customers' orders ("bucketing").

Hypothecating or selling a customer's securities, by a broker, without the customer's consent, except where the broker has a lien on the securities for an unpaid purchase price. (See sec. 586.)

Issuing fraudulent checks, and so on. (See sec. 390.)

43. Miscellaneous crimes and violations. With the growing complexity of modern existence, public policy has dictated that many acts and omissions not necessarily vicious in themselves be classed as crimes to safeguard the public welfare. In many of these cases, the element of criminal intent is immaterial; otherwise conviction would be difficult, if not impossible. These statutes, for the most part, deal with the following:

Prohibition of antisocial enterprises, such as lotteries, gambling devices, sale of narcotics, sale of liquor and tobacco to minors, and so on.

Professional and technical standards. Many statutes aim to protect the public against incompetent or unscrupulous professional or technical serv-

ices, by regulations in respect to licensing, disciplinary proceedings, suspension or revocation of a license, penalties for practicing without a license, and so on. These services concern certified public accountants (sec. 44), attorneys (sec. 45), physicians, nurses, dentists, pharmacists, osteopaths, veterinarians, optometrists, architects (sec. 161), civil engineers, surveyors, embalmers, chiropractors, chiropodists and others engaged in rendering professional or technical service to the public generally.

Business licenses, certificates of approval, and so on. Statutes may prescribe penalties for engaging in certain businesses without prior public approval, where such businesses are of sufficient public concern to justify such regulation. Examples are the requirement for obtaining government approval before engaging in the banking or insurance business, or in public utilities, such as waterworks, railroad, bus or other transportation services, electric light, telephone or similar public service enterprises. Licenses are commonly required in connection with collection and employment agencies, theaters, hospitals, hotels, investment companies, mining or oil properties, cold storage plants, and so on. State statutes commonly prescribe penalties for doing business under a fictitious or trade name without first registering such name and disclosing the true name of the proprietor.

Public safety. Numerous statutes concerned with public safety prohibit or restrict the sale and possession of firearms; regulate factory conditions, child labor and the employment of women in industry; prescribe rules governing the ownership and operation of motor vehicles and the regulation of traffic; impose regulations to protect against fire hazards; and fix building safety requirements, such as building plans, specifications as to building materials, elevator inspections and similar building precautions.

Sanitation. Many statutes, including local ordinances, deal with plumbing and sewage disposal, meat, fruit and vegetable canneries, food handling and packing under prescribed sanitary conditions by employees free from contagious diseases, purity of foods and drugs and proper labeling and disclosure of their contents, barbers and barber shops, beauty parlors, the sale of secondhand mattresses or upholstered furniture containing padding or stuffing, and numerous other items affecting public health and sanitation.

Consumer protection. A variety of statutes and local ordinances prescribe standards governing the size of containers, true weights and measures and similar items helpful in protecting consumers against unscrupulous manufacturers, producers and dealers.

Sunday laws. State laws and particularly local ordinances aim at restricting business activities on Sunday. Violations are generally punishable by fines. Exceptions are usually made in the case of services and supplies of "public convenience and necessity," such as medical and surgical attendance, emergency repairs, church subscriptions, Sunday newspapers, drugs, motion picture and other entertainment, and (subject to local regulation) dairy, delicatessen and other foods within limited hours.

Bankruptcy crimes. The Bankruptcy Act prescribes penalties for a variety of illegal business practices connected with bankruptcy. (See secs. 1348-1349.)

Of special note are statutes governing the unlawful practice of accountancy and of law, and certain offenses commonly designated "business crimes."

44. **Unlawful practice of accountancy.** Legislation governing the practice of accountancy in the United States is far from uniform. Usually it provides for restrictions on the use of the designation "Certified Public Accountant" or "C.P.A.," rather than on the practice of accountancy itself.

A minority of states have adopted statutes restricting practice to state-licensed public accountants. These states include Maryland and Louisiana (1924), North Carolina, Tennessee and Michigan (1925), Illinois and Florida (1927), Virginia (1928), Iowa (1929), Mississippi (1930), Arizona (1933), Wisconsin (1935) and Colorado (1937).

New York. The New York statute provides for examination and admission to practice as certified public accountants through the issuance of state certificates by a board of certified public accountant examiners appointed by the state regents. Penalties are provided for engaging in the public practice of accountancy as a certified public accountant without having been certified as such by the state. Anyone who, without being certified, holds himself out as a certified public accountant engaged in the public practice of accountancy or who uses the title "certified public accountant" or "C.P.A." is guilty of a misdemeanor punishable by imprisonment for not more than one year, or by a fine of not more than \$500, or by both, for each separate offense. In addition, the attorney-general may recover a civil penalty from such person of \$100 for each offense, whether separate offenses are committed on the same day or not. Certified public accountants convicted of a felony, or of the misdemeanor of having previously practiced without a state certificate, or of any atrocious crime, are automatically subject to revocation or suspension of their C.P.A. certificates. The New York statute makes no effort, however, to restrict the practice of public accountancy itself.

Illinois. The Illinois statute (as amended in 1943) makes it unlawful to practice public accountancy except as a registered public accountant. Corporations cannot practice public accountancy (except those registered before the law was passed). In addition, the University of Illinois issues certificates, upon examinations for such purpose, of qualification as expert public accountants, holders of which are entitled to the designation "certified public accountant" or "C.P.A." Each of the following acts constitutes a misdemeanor punishable by a fine of not less than \$100 nor more than \$1000, or by imprisonment for not more than six months, or both:

- (a) Practicing, without license, as a public accountant.
- (b) Obtaining registration by fraud.
- (c) Using the designation "certified public accountant" or "C.P.A." without certificate from the University.

(d) Use by a partnership of the designation, "certified public accountant" or "C.P.A.," unless all partners have received certificates from the University and are registered as public accountants.

(e) Using the designation "public accountant" or an abbreviation thereof without registration.

(f) Use by a partnership of the designation "public accountant" or an abbreviation thereof unless all partners are registered.

45. Unlawful practice of law. Anyone may be his own lawyer, but if he acts or holds himself out as authorized to act as a lawyer for another, or if he engages in the practice of furnishing legal advice or drawing up legal papers other than on his own behalf without having been admitted to the practice of the law, he is guilty of practicing law unlawfully and punishable accordingly. The New York statute in this connection is typical. It makes it unlawful for anyone not duly licensed:

(a) To practice, or to appear in court as attorney or counsellor-at-law, except on his own behalf;

(b) To hold himself out to the public as being entitled to practice law;

(c) To assume, use or advertise the title of lawyer, attorney and counsellor-at-law, or similar title;

(d) To ask or receive, directly or indirectly, compensation for preparing deeds, mortgages, assignments, discharges, leases, wills, and so on, or pleadings (sec. 73) of any kind.

Violation of any of these provisions is a misdemeanor.

Solicitations of retainers or legal business, directly or indirectly, are likewise prohibited. The New York statute provides:

(a) An attorney must not buy, procure an assignment of, or in any way be interested in buying or acquiring, a bond, promissory note, bill of exchange, or other claim for the purpose of bringing suit on it.

(b) An attorney must not offer any valuable consideration as an inducement for bringing him legal work.

(c) Corporations and collection agencies are forbidden to deal in claims for lawsuit purposes.

Any attorney guilty of deceit or collusion with intent to deceive the court or any party, or who wilfully delays his client's suit for his own benefit, or who wilfully receives money or allowance on account of moneys not really laid out by him, is not only guilty of a misdemeanor but may forfeit treble damages to the party injured.

An agreement to share legal fees between a lawyer and a layman, whether the latter be an individual, partnership, corporation or association, makes all participants guilty of a misdemeanor.

46. Falsifying records. Most states prescribe severe penalties for falsifying books and records. The New York statute is

typical of many others. A person is guilty of forgery in the third degree punishable by imprisonment for not more than five years if:

(A) As an individual, officer or employee of a corporation, association or partnership, he falsifies or unlawfully and corruptly alters, erases, obliterates or destroys any accounts, books of account, records or other writing pertaining to the business of said individual, corporation, and so on;

(B) With intent to defraud or to conceal any larceny or misappropriation by any person of any money or property, he does any of the following things:

(1) Alters, erases, obliterates, or destroys an account, book of accounts, record, or writing, belonging to, or appertaining to the business of, a corporation, association, public office or officer, partnership or individual; or,

(2) Makes a false entry in any such account or book of accounts; or,

(3) Wilfully omits to make true entry of any material particular in any such account or book of accounts, made, written, or kept by him or under his direction.

Similar alterations are declared to constitute forgery in the third degree if made:

(a) With intent to defraud creditors, or

(b) To conceal a crime, or

(c) To conceal from creditors or stockholders or other persons interested, matters materially affecting the financial condition of any individual, corporation, association or partnership, or

(d) To provide a basis for obtaining credit.

The foregoing provisions do not apply to a clerk, bookkeeper or other employee who, without personal profit or gain, merely executes the orders of his employer.

The effect of these penal provisions is to aggravate crimes which are accompanied by false record entries.

Example: Two cashiers steal different sums from their corporate employer. *A* takes currency received by him as the proceeds of a note receivable which has never been entered on the corporation's books. *B* takes currency from the cash drawer and makes an entry charging the withdrawal on the corporation's books to an expense account. *A* is guilty of larceny by embezzlement, but *B* is guilty not only of larceny but of forgery in the third degree.

47. Unexplained shortage in accounts. A mere unexplained shortage in accounts is not necessarily criminal, because it does not of itself establish a fraudulent intent to deprive the owner of anything: the shortage might be due to carelessness. Thus, if a cashier is found to be short in his accounts and admits the fact, but is unable to explain the deficiency, he cannot be con-

victed of embezzlement unless there is additional proof that he has deliberately appropriated the difference.

48. False financial statements. Penal statutes throughout the country generally prescribe fines and imprisonment for obtaining credit by false financial statements. Again the New York statute is characteristic. It makes the following classes of persons liable under the statute:

(a) A person who, to secure credit, *knowingly makes or causes to be made* a false written statement concerning the financial condition or ability to pay of himself or of some other person, firm or corporation in which he is interested or for whom he is acting;

(b) A person who, *knowing that such a statement has been made* concerning himself or some other person, firm or corporation in which he is interested or for whom he is acting, procures money, property or credit on the faith of such statement; and

(c) A person who, knowing that a written statement has been made concerning the financial condition or ability to pay of himself or some other person, firm or corporation in which he is interested or for whom he is acting, *"represents on a later day, either orally or in writing, that such statement theretofore⁵ made, if then again made on said day, would be then true, when in fact, said statement if then made would be false,"* and who procures money, property or credit upon the faith of such oral or written statement.

C. Governmental Powers and Limitations

49. Force essential to law. Without the force of authority, law would be a mere collection of rules. Hence "the supreme power in a state" not only prescribes rules of civil conduct, but enforces them. The organization of this supreme power is Government.

50. Dual sovereignty: delegation of authority. Our system of government represents a dual sovereignty: the states, originally sovereign, have by the United States Constitution delegated certain paramount authority to the United States Government, reserving to themselves all sovereign authority not thus delegated. Hence each state, while sovereign, is subject not only to its own constitution but also to the United States Constitution, which is "the supreme law of the land." Under each state constitution, governmental power may be further delegated to subordinate units for local government, such as

⁵ The original statute, as reported in *McKinney's Consolidated Laws*, reads "therefore," but undoubtedly "theretofore" was intended.

counties, cities, towns and villages. Such delegated authority is circumscribed by constitution, statute and charter.

For example, in determining the validity of a municipal bond issue, we must ascertain whether the delegation and exercise of sovereign authority are within constitutional limits: "whether the municipality was authorized to issue the bonds, for the purpose under consideration; whether the debt limit has been exceeded, whether the preliminary steps required by law have been taken; whether proper provision has been made for the payment of the bonds; whether the bonds are in the proper form; whether they have been duly executed and delivered by the proper officers; and whether they have been sold or disposed of in accordance with law."⁶

51. Constitutionality. Any act of Congress which fails to conform to the United States Constitution, and any state statute or municipal ordinance which fails to conform to both Federal and state constitutions, is "unconstitutional" and void. It is therefore of paramount importance that we understand the basic framework of the Constitution of the United States.

52. Basic framework of Constitution. The Constitution of the United States does three things: (1) it prescribes the form and specifies the powers of the government it creates; (2) by way of guaranty and safeguard it limits the powers not only of the government it creates (the Federal government) but also, in certain respects, of the states themselves; and (3) it provides for amendments. Every act of Congress must find its authority in these powers. Every act of government, Federal, state or local, is subject to these limitations.

53. Constitutional powers and functions. The Constitution distributes all Federal powers and functions into three separate departments, executive, legislative and judicial. For any of these departments to transgress the others is to violate the Constitution.

54. Congressional powers: in general. Congress may: raise money by taxation and duties on a uniform basis throughout the country, borrow money on credit, regulate commerce among the states and with foreign nations, establish uniform rules on naturalization, enact bankruptcy laws, coin and issue money and punish for counterfeiting, fix standards of weights and measures, establish post offices and post roads, enact copy-

⁶ 44 *Corpus Juris* 1226.

right and patent laws, establish Federal courts inferior to the United States Supreme Court, punish for crimes committed on the high seas and acts in violation of international law, declare war, raise and support armies, provide and maintain a navy, govern the district which is the seat of the government (District of Columbia) and make all laws necessary and proper for carrying into effect the foregoing powers.

55. Congressional powers: valid exercise. Every act of Congress must fall within the framework of its specifically delegated powers.

For example, provisions for corporate reorganizations (sec. 1350) and for individual and corporate "arrangements" (sec. 1353) fall within the power given to Congress to enact bankruptcy laws.

The following acts of Congress were passed under its constitutional power to regulate interstate commerce:

Sherman Anti-Trust Act (1890), which declared every combination in restraint of trade illegal.

Clayton Act (1914), which was designed to strengthen the Sherman Anti-Trust Act and which established the Federal Trade Commission to investigate unfair business practices and check monopolistic tendencies.

Robinson-Patman Act (1936), intended to strengthen and supplement the Clayton Act by making it unlawful directly or indirectly to discriminate in price between buyers, large or small, of commodities of like grade and quality (sec. 1363).

Tydings-Miller Act (1937), which modified the Sherman Anti-Trust Act by legalizing resale price maintenance agreements upon certain conditions (sec. 1363).

Securities Act (1933), which was designed to accomplish two objectives: (1) to provide full and fair disclosure to prospective investors of the character of new securities or new offerings and (2) to prevent fraud or misrepresentation in the sale of securities, old and new.

Securities Exchange Act (1934), which was adopted: (1) to establish Federal regulation over securities exchanges and markets, (2) to prevent unfair practices on such exchanges and markets, (3) to discourage and prevent the use of credit in financing excessive speculation in securities, (4) to compel corporations to furnish adequate information on securities publicly traded in and (5) to control unfair use of information by corporate insiders.

Fair Labor Standards Act (Wage and Hour Act), passed in 1938, fixing minimum wages and maximum hours for employees engaged in interstate commerce or in producing goods for interstate commerce.

National Labor Relations Act (1935), designed to safeguard the right of labor to bargain collectively (sec. 614).

56. Congressional powers: invalid exercise. Two outstanding examples of the invalid exercise of Congressional powers are:

National Industrial Recovery Act (N.R.A.), passed in 1933. This act permitted trade and industry to police themselves by drawing up codes of fair competition subject to approval by the President of the United States. The act was declared unconstitutional because (1) it delegated *legislative* power to the *executive* department and (2) it sought to regulate business not truly *interstate*. (But see sec. 59.)

First Agricultural Adjustment Act (1st AAA), passed in 1933. This act sought to restore the farmer's purchasing power by adjusting production to demand and compensating farmers who cut down their crops, out of a fund raised through taxes on processing the farm product. The act was declared unconstitutional on the following grounds: (1) Farming is not interstate commerce; (2) the tax was not collected for government support generally but took from one group for the benefit of another; and (3) the act invaded the reserved rights of the states. The *Second Agricultural Adjustment Act (2nd AAA)*, however, which omitted the processing tax and restricted marketing of farm products to a volume determinable by the Department of Agriculture, was upheld.

57. Limitations on Congressional powers. The Constitution of the United States imposes specific limitations on Congressional power. Congress may not: suspend the writ of habeas corpus, take away the property of a person condemned to death (bill of attainder), pass criminal laws to govern acts committed prior to the enactment of the law (*ex post facto* laws), tax exports, give preference to any domestic port or compel vessels doing an interstate business to pay duty, grant titles of nobility (an officeholder may not accept any present, office, or title from any foreign land or its head without the consent of Congress).

58. Limitations on states. In addition to prohibitions in respect to attainders, *ex post facto* laws and titles of nobility, no state may make treaties, issue money, pass any law impairing the obligation of contracts, lay import or export duties, tax marine tonnage, keep armies or warships in peacetime, or engage in war unless actually invaded or in imminent danger.

59. Expansion of commerce clause. Most debated, perhaps, of all Federal powers is that embodied in the clause which gives Congress power to regulate interstate commerce. Both words, "commerce" and "interstate," have been broadened considerably by judicial interpretation.

Commerce, it was originally contended, means trade. Chief

Justice Marshall broadened the definition⁷ to include not only merchandise carried in trade but the carriers as well. From carriers of merchandise the interpretation broadened to carriers of passengers, later to the transmission of intelligence or electric power by wire (including telegraph, telephone and power companies), and still later to motor transportation, radio broadcasting and airplane travel and transportation. The Supreme Court even defined news as commerce when it held that the National Labor Relations Board could order the Associated Press to rehire employees who had been discharged because of union activity.⁸

The interpretation of "commerce" is no longer confined to trade, transportation, or the transmission of power or intelligence. Congress is held to have power to regulate all forms of interstate business and industry: to pass antitrust laws (sec. 55), to legislate on trade-marks and trade names, to quarantine cattle, prohibit interstate traffic in lottery tickets or the shipment of mislabeled food and drugs, and to legislate on all phases of labor directly or indirectly concerned with interstate business—hours, wages, fair practices and collective bargaining.

Interstate, literally, means between states, as distinguished from *intrastate*, which means within a state. The original concept of intrastate commerce was that of commerce inside the borders of a single state, as opposed to commerce between states. The expansion of the "interstate" concept is illustrated in the following cases:

In *Hammer v. Dagenhart* (1918),⁹ the United States Supreme Court voided an act of Congress which sought to prohibit interstate shipment of goods made in factories employing child labor. Congress, said the Court, had no such power under the commerce clause. But in *United States v. Darby Lumber Company* (1941),¹⁰ the Supreme Court, in approving the Fair Labor Standards Act (sec. 55), held that if a person *produced* goods for interstate commerce he was subject to Federal regulation—specifically reversing its prior decision in *Hammer v. Dagenhart*.

In the *N.R.A. Case* (*Schechter Poultry Corp. v. U.S.*),¹¹ decided in 1935, the National Recovery Administration sought to fine dealers for violating the poultry code. The poultry was slaughtered in New York, sold to re-

⁷ *Gibbons v. Ogden*, 9 Wheat., 1.

⁸ *Associated Press v. National Labor Relations Board*, 301 U.S. 103.

⁹ 247 U.S. 251.

¹⁰ 312 U.S. 100.

¹¹ 295 U.S. 495.

tailers in New York, and resold to consumers in New York; but the business had a competitive influence outside New York. The Supreme Court, as already noted (sec. 56), invalidated the act, not only on the ground that it delegated legislative power to the executive department but also on the ground that it sought to regulate *intrastate* commerce. Indirect effect on interstate commerce was held immaterial. But in *U.S. v. Wrightwood Dairy Co.*¹² (1942), the Supreme Court held that milk processed exclusively in Illinois, in competition with interstate handlers in that area, *indirectly affected* interstate commerce and was therefore subject to Federal regulation.

Other decisions which have broadened the scope of interstate commerce are as follows:

*N.L.R.B. v. Fainblatt*¹³ (1939). A small New York clothing manufacturer bought all his raw material in New York and sold all his garments to a New York concern, which shipped to customers, some of whom were outside the state. The Court held that the clothing manufacturer was subject to Federal labor regulation because labor disputes might lead to strikes, strikes might reduce output, and reduced output might curtail interstate shipments.

*Wickard v. Filburn*¹⁴ (1942). A small farmer exceeded his wheat-raising allotment under the Agricultural Adjustment Act by twelve acres, for which he was assessed. To the farmer's plea that his wheat-raising was for local consumption, the Supreme Court replied that such consumption might affect interstate commerce, hence was subject to Federal regulation.

*Kirschbaum v. Walling*¹⁵ (1942). The Supreme Court held that the wages and hours of porters, elevator operators, and night watchmen in a New York City loft building were subject to Federal regulation under the Fair Labor Standards Act, because: (1) Some of the tenants were engaged in interstate commerce, hence (2) the building employees were engaged in occupations necessary to the production of goods for interstate commerce.

60. Constitutional guaranties and safeguards. Embedded in the Constitution are certain fundamental guaranties, safeguards and limitations, serving as a bulwark to protect minorities against oppression. These include:

Personal, civil and political rights and safeguards: personal liberty, personal security, freedom of religion, freedom of speech and the press, right of assembly and petition, equal protection of the laws and the prohibition of special privileges, immunities and class legislation.

Specific guaranties affecting property rights, including the provision against impairing the obligation of contracts and certain restrictions on the exercise of such dominant powers as eminent domain and taxation.

¹² 315 U.S. 110.

¹³ 306 U.S. 601.

¹⁴ 317 U.S. 111.

¹⁵ 316 U.S. 517.

61. Liberty and security. Reference has already been made to the "natural" rights of personal liberty (sec. 20) and personal security (sec. 19), including the safeguards of bail and *habeas corpus*. The guaranty of personal liberty, implicit in numerous provisions of the Constitution, is specifically mentioned in the Fifth Amendment, which provides that no person shall be deprived of life, liberty or property without due process, and the Fourteenth Amendment, which reiterates the prohibition as to the states. Personal security is safeguarded by the following restrictions:

Criminal prosecution. No person may be held for a capital or infamous crime save on "presentment or indictment of a grand jury" (except in military and naval cases under wartime conditions).

Double jeopardy. No person may be twice put in jeopardy of life or limb for the same offense. A person acquitted cannot be tried again for the same offense.

Self incrimination. No person may be compelled in any criminal case to be a witness against himself.

Cruel and inhuman punishments are prohibited by the Constitution. Hence confessions tortured out of a prisoner are frequently kept out of evidence.

Excessive fines and bail are prohibited by the Constitution.

Ex post facto laws. Any law which imposes punishment for an act not punishable when committed, or new punishment for an act in addition to that in force when the act was committed, is forbidden.

62. Freedom of religion. The first of the ten amendments (Bill of Rights) provides: "Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof." The sixth article of the Constitution further provides that "no religious test shall ever be required as a qualification to any office or public trust under the United States."

63. Freedom of speech and the press. The First Amendment provides that Congress shall make no law abridging the freedom of speech or of the press. No law may be passed which limits our right, by the spoken or written word, to criticise any public or private act. On the other hand, as the Supreme Court observes, "The freedom of speech and the press does not permit the publication of libels, blasphemous or indecent articles or other publications indecent to public morals or private reputation."

64. Right of assembly and petition. The First Amendment guarantees the right of any and all persons, individually or collectively, to apply to any officer or department of government for relief or the redress of grievances—free of all penalty for having sought or obtained it.

65. Equal protection of the laws. The Fourteenth Amendment provides that no state shall “deny to any person within its jurisdiction the equal protection of the laws.” It is a denial of equal protection to pass legislation which discriminates against some persons in favor of others (see sec. 56, First Agricultural Adjustment Act). In this sense, “persons” includes corporations. The law may discriminate, however, where real differences exist, such as differences in age, sex, professions and trade.

66. Privileges, immunities, and class legislation. The Fourth Article of the Constitution provides that “the Citizens of each state shall be entitled to all Privileges and Immunities of Citizens in the several States.” For example, a state law giving priority to its own creditors is void.¹⁶ The Fourteenth Amendment further provides that “no state shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States.” Hence no statute may prevent a citizen from passing freely from one state to another or from doing business in any state other than his own.

Who are citizens: Persons are citizens of the United States if they are (1) born in the United States, or (2) born abroad of parents who are American citizens, or (3) duly naturalized. Persons may be naturalized (a) by personal compliance with civil naturalization laws, including five years’ residence, declaration of intention and oath of allegiance, (b) by parent’s naturalization, or (c) by military service in the armed forces of the United States. Formerly, a female alien acquired citizenship upon marriage to an American citizen. Under the act of Congress of 1922, as amended in 1930, 1931 and 1934, citizenship is not acquired by marriage, but if an alien spouse is otherwise eligible, he or she may become a citizen upon full compliance with the naturalization laws, without declaration of intention, and upon three years’ residence prior to filing of petition instead of the normal five-year period.

Corporations are not included within this constitutional provision. The provision relates to *citizens*. Although corporations have been judicially declared to be *persons*, they are not and cannot be citizens. Hence any state may refuse, limit, or regulate the right of corporations organized in other states to enter that state and conduct business therein (secs. 872-873).

¹⁶ *Blake v. McClung*, 172 U.S. 239, 247; 176 U.S. 59.

67. Impairing obligation of contracts: police power. The Constitution provides that "no state shall . . . pass any . . . law impairing the obligation of contracts." The provision is directed at state action, including state constitutions and statutes. It does not apply to Congress.

Police power. The constitutional limitation on state impairment of contract obligations is subject to the implied reservation of state sovereignty and all necessary measures to protect it, which come under the general designation "police power," or the dominant power of a sovereign government to pass laws for the promotion of public health, safety, morals and general welfare. Hence tenement house legislation, sanitary laws, emergency rent laws and laws fixing maximum or minimum prices for public necessities may impair the obligation of contracts without violating the Constitution.

68. Eminent domain. The right of a sovereign power to take private property for public use is limited by the Fifth Amendment, which commands *just compensation* to the owner, and by the *due process clause*, which provides that no person may be deprived of his life, liberty or property without due process of the law. The power of eminent domain may be exercised by a government directly, as where it condemns property for a post office, courthouse or public road, or it may be delegated to a corporation or individual together with the delegation of some public duty or function, as in the case of railroad, telegraph or telephone rights of way. There can be no right of eminent domain unless the purpose is truly public.

Condemnation proceedings. Where a property owner resists surrender of his property, either because he challenges the purpose as not truly public or because of disagreement in the amount of compensation, condemnation proceedings must be instituted. Such proceedings may vary in detail. The Constitution of the State of New York, for example, provides several ways of determining compensation: (1) by a jury, (2) by the state supreme court with or without a jury, and (3) by not less than three commissioners appointed by a court of record. The property taken must be free and clear of all claims, including not only the owner's interest, but also all liens (Chapter XIII), easements (sec. 1035), and leaseholds (sec. 1118); and the amount awarded must be distributed among these claimants, unless there is an agreement with the owner (as in some leases) that in case of condemnation proceedings the owner takes all. The award also embraces all improvements, including fixtures which have become part of the realty (sec. 1364).

69. Taxation. The power to tax is essential to the very existence of a state. Hence, taxes may with constitutional impunity cut into property and contract rights provided their

purpose is public and their imposition uniform. A fundamental distinction in taxing power should be noted between Federal and state governments: each state has the unlimited power to tax which goes with sovereignty, but Federal taxation must be limited to the specific purposes delegated by the United States Constitution. Taxes may be collected upon the basis of an *assessment*, as in the case of real and personal property taxes; or upon the basis of a *return*, made out and filed by the taxpayer, usually accompanied by his remittance; civil and criminal penalties being imposed for failure to make the return. Many taxpayers are required to furnish complete accounting information, balance sheets, and so on, as a basis for tax computation.

Taxation must be for a truly public purpose. If the levy is on one group for the benefit of another (sec. 56), the tax is unconstitutional.

70. Due process. All dominant government powers, including eminent domain, the police power and the power to tax, as well as all private rights and powers, are subject to the all-inclusive constitutional limitation of due process. The Fifth Amendment, as noted (sec. 61), provides that no person shall "be deprived of life, liberty, or property, without due process of law," and the Fourteenth Amendment applies the provision specifically to the states. The term "due process" has been given widely varying interpretations, but the concept corresponds roughly to that of "the law of the land" (sec. 2).

D. Procedure

71. Prosecutions *v.* lawsuits. The state punishes a criminal by apprehending him, bringing him to trial and, if guilty, imposing sentence. The procedure is known as a "prosecution." A "lawsuit," on the other hand, or "civil" suit, involves a private dispute wherein a person wronged by another seeks redress against the latter in the form of money damages, recovery of property, or some special form of equitable relief, such as injunction, specific performance, partition, foreclosure, accounting, rescission, or the enforcement of a trust.

72. Criminal prosecution. A criminal prosecution is usually instituted either by a warrant for a person's arrest, or by a sworn "information" on which a magistrate issues a summons or writ directing the accused to appear before him. In minor

cases the magistrate tries the accused and either acquits him or imposes a penalty; in serious cases, he has jurisdiction only to commit the accused to prison (subject to bail), to await grand jury action.

The grand jury usually consists of twenty-three men convened from time to time to investigate charges of crime laid before it. Proceedings before a grand jury are not in the nature of a trial, but are one-sided, that is, the district attorney, representing the state, merely presents the evidence. If the grand jury finds that a crime has been committed, it draws up a written accusation ("finds an indictment") on which the accused is tried. If, as sometimes happens, the evidence comes before the grand jury in the first instance, the criminal being at large, an indictment is found, and the authorities endeavor to arrest the criminal and bring him to trial on the indictment.

On the trial, three things must be established: (1) the *corpus delicti*, or body of the offense, that is, the commission of the crime itself; (2) the connection of the accused with the crime; and (3) guilty motive or intent, except where intent, under the statute, is not a necessary element of the crime (sec. 32). As to intent, the law presumes that everyone contemplates the natural consequence of his act. In criminal cases, guilt must be established beyond a reasonable doubt.

73. Lawsuits and judgments. The object of a lawsuit is to obtain a legal determination requiring a person to do or refrain from doing some thing.

Summons, parties, jurisdiction. A lawsuit is started by the service of a writ or summons. The person suing (*plaintiff*) causes the writ to be handed to ("served on") the person sued (*defendant*), and this requires the latter to appear in court on or by a given date. This gives the court "jurisdiction."

Pleadings, issues, court calendar. The wrong to the plaintiff is set forth in a complaint (known as "declaration" in some states), to which the defendant must serve his answer ("plea" in some states), and also, if he sees fit, any cross-charge or *counterclaim* to the plaintiff's complaint, to which the plaintiff may *reply*. These charges, defenses and cross-charges are known as the *pleadings*, which create the *issues* in a case. These issues are brought to trial by being put upon the *court calendar*.

Trial. Upon the "call" of the calendar, the case is tried when reached. The attorneys for both sides select or *impanel* a jury; then "open" to the jury, that is, explain the nature of their respective contentions. The plaintiff's attorney puts on plaintiff's witnesses in any order he may select, elicits their testimony in the first instance by "direct examination," then

must submit them to "cross-examination" by the defendant's attorney. The defendant's attorney then puts on defendant's witnesses, who likewise testify upon direct and cross-examination. The plaintiff need not establish his case, as in a criminal prosecution, beyond a reasonable doubt but by a preponderance of evidence, which is not measured by the number of witnesses but by the quality of their testimony. The attorneys then *sum up* the evidence, the court *charges* (instructs) the jury on the law, and the jury "retires" to deliberate on the facts.

Judgment, execution, levy. If the jury finds for the defendant, the case is *dismissed*; if for the plaintiff, a *judgment* is entered for the amount found, and the judgment is carried out by *issuing execution* to a sheriff or marshal, who must make demand for payment and, if such demand is not met, seize or *levy upon* defendant's property and cause it to be sold to satisfy the judgment.

Supplementary proceedings. If the sheriff or marshal, unable to find property belonging to the defendant, *returns the execution unsatisfied*, plaintiff's attorney may obtain a court order, or, in some states, may issue his own subpoena, for the examination in *supplementary proceedings* of the defendant (now known as *judgment debtor*), to ascertain, if possible, the existence of any property or income which might make the judgment collectible.

Garnishment. If the judgment debtor has no money or property in his possession, but money or property is due him from a third party, the *judgment creditor* (successful plaintiff) may institute *garnishment* proceedings to satisfy his judgment. The third party who owes the debt to the judgment debtor and against whom such proceedings are brought, is called the *garnishee* (sec. 1365, subd. a). Where the garnishee is an employer owing wages to the judgment debtor, the proceedings are sometimes referred to as *execution against income*. An employer need not withhold the entire wage, but only a percentage (usually 10%) fixed by statute. Any excess over such percentage which the employer may have withheld belongs to the employee (sec. 1365, subd. b). Statutes generally prescribe a fixed minimum wage which is not subject to garnishment.

Attachment. In exceptional situations (as, for example, where the defendant is a nonresident or threatens to leave the jurisdiction, an action may be begun by a writ of attachment, commanding the sheriff to seize the defendant's property as security for the satisfaction of such judgment as the plaintiff may recover. •

74. Courts. A court consists of judge and jury. The judge expounds the law; the jury finds the facts. Equity or *chancery* cases are usually tried by a judge without a jury; and where the facts are involved, detailed or complicated, as they frequently are in patent and other litigation, the court may refer the case for fact-finding purposes to a *master in chancery* or *referee*. A court has no power over a party unless it obtains *jurisdiction*, or authority to render a binding decision. The

jurisdiction of the various courts depends on various factors: residence of the parties, amount in suit, nature of case, location of property (in real property cases), and so on. Jurisdiction may be *original* (for trial in the first instance) or *appellate* (for review of a lower court).

75. Evidence: object of. All testimony given upon a trial must conform to certain rules of evidence, the object of which is to establish the truth or falsity of a given charge or assertion.

Judicial notice. Certain matters of common knowledge need not be proved; the court will take "judicial notice" of them.

76. Burden of proof. The *burden of proof* is on the party holding the affirmative (usually the plaintiff); that is, he must go forward with enough proof so that if nothing were shown to the contrary, he would win. This puts the burden on the defendant. If the defendant fails to meet the burden with equal proof to the contrary, the plaintiff is entitled to judgment. If the defendant meets the burden and the plaintiff fails to present additional proof to outweigh the defendant's, the case is dismissed.

77. Classifications of evidence. There are numerous classes of evidence, including, among others, the following: *prima facie*, conclusive, direct, indirect or circumstantial, real, relevant, material, competent, primary or "best," secondary and hearsay.

78. Prima facie evidence. *Prima facie* evidence is evidence which, standing alone, unexplained or uncontradicted, establishes the proposition or conclusion to support which it is introduced. For example, *prima facie* evidence of a debt is evidence which, if not controverted by evidence to the contrary, establishes the existence of the debt.

79. Conclusive evidence. Conclusive evidence is evidence which is incontrovertible (a) as a matter of law, such as the presumption of ownership from adverse use (sec. 1041), or (b) as a matter of fact, such as evidence from which only one reasonable conclusion can be drawn.

80. Direct evidence. Direct evidence consists of testimony by persons who saw, heard or sensed the matter in controversy, so that they can testify on direct knowledge. "If, for example, it is desired to ascertain whether the accused has lost his

right hand and wears an iron hook in place of it, one source of belief on the subject would be the testimony of witnesses who had seen the arm.”¹⁷

81. Indirect or circumstantial evidence. Indirect or circumstantial evidence is evidence which tends to establish a fact, not by direct proof of its existence but by indirect proof from which a logical inference may be drawn. To use Wigmore's illustration again, the mark of the hook on something carried by the accused would furnish circumstantial evidence that the accused wore a hook in place of his hand.

82. Real evidence. Real evidence is that derived from personal observation by the court and jury. Again using Wigmore's illustration, if the jury inspected the accused's arm and saw the hook, this would constitute real evidence.

83. Relevant and material evidence. Relevant and material evidence are closely akin. Evidence is relevant when it touches the issues and assists in determining their truth, material when it is not only relevant but also has a direct bearing on the decision. “The practical conditions under which cases are tried do not always permit the court to hear all facts which may be in any degree logically relevant to the issue, but requires that the facts received shall have a somewhat higher degree of probative force, which may be termed ‘legal relevancy’ or ‘materiality.’ The rule in this connection is that whenever the court feels that a fact is not of probative value commensurate with the time required for its use as evidence, either because too remote in time, or too uncertain or too conjectural in its nature, the fact may in the exercise of a sound discretion be rejected.”¹⁸

84. Competent evidence. “By competent evidence,” says Greenleaf,¹⁹ “is meant that which the very nature of the thing to be proved requires, as the fit and appropriate proof in the particular case, such as the production of a writing where its contents are the subject of inquiry.” If proof is incompetent, it is inadmissible, however relevant it may be. Thus, in a breach of contract action, testimony on the contents of a written contract may be relevant, yet if the contract itself is available, the testimony will be incompetent and hence inad-

¹⁷ *Wigmore on Evidence*, sec. 1150.

¹⁸ *22 Corpus Juris* 162-4.

¹⁹ *Evidence*, 16th Ed., sec. 2.

missible, because the contract itself will be the proper evidence.

Competent *testimony* is distinguished from competent *evidence*, in that it relates to the witness rather than to the evidence. Incompetent witnesses may include insane persons, infants of tender age, and persons in a complete state of intoxication. Witnesses interested in the event (a plaintiff or defendant, for example) are deemed biased but not necessarily incompetent, except as against the estate or survivors of a deceased person, in which case, "since death has silenced the one, the law will silence the other."

85. Privileged communications. Because of their peculiarly confidential relationships, certain parties are made incompetent by law to testify as to "privileged" communications between them.

Attorney and client. An attorney or counsellor at law is not allowed to disclose a communication made to him by his client or his advice to the client thereon. This includes any clerk, stenographer or other person employed by the attorney, such as an interpreter (sec. 1369, subd. b). The client, however, may waive this privilege, and if he does, the attorney may be compelled to testify.

Physician and patient. Physicians are forbidden to disclose information acquired in a professional capacity, unless the patient waives the privilege.

Clergymen and penitent. Confessions or admissions made to a clergyman or priest in his professional capacity are privileged. (Some states refuse to recognize this privilege.)

Husband and wife. At common law, the husband or wife of a party to an action was wholly incompetent to testify as a witness. Statutes have largely qualified this rule. Husband and wife may now generally testify for or against each other except as to confidential matters between them. Neither may testify against the other in divorce actions except to prove the marriage or to disprove accusations or defenses to accusations.

86. Communications not privileged. The mere fact that a communication is imparted in confidence does not make it privileged. Hence confidential information imparted to or acquired by bookkeepers, detectives, merchants, bankers, agents, copartners or business employees generally cannot be refused on the witness stand, though to disclose it voluntarily might constitute a breach of contract or breach of faith. "No pledge of privacy nor of secrecy can avail against the demand for truth in a court of justice."²⁰

²⁰ *Wigmore on Evidence*, sec. 2286.

Newspaper editors and reporters. "The rule of privileged communications does not apply to communications to a newspaper editor or reporter, for, although there is a canon of journalistic ethics forbidding the disclosure of a newspaper's source of information, it is subject to qualification and must yield when in conflict with the interests of justice. Accordingly, a witness before the grand jury on a complaint for libel published in a newspaper may be required to disclose the name of the writer, which he admits he knows, over the objection that it is an office regulation that the editors of the paper are not to give the name of the writer of articles published in it."²¹

Accountants. Under the common law (that is, in the absence of statute), there is no privilege with regard to communications made to an accountant. "The information given to the witness and to the accountants in his employ for the purpose of making financial statements and doing other work characteristically performed by accountants is not privileged, despite the fact that the witness may also have rendered legal advice on the basis of such data."²² However, in some states communications to accountants in their confidential capacity have been made privileged by statute. In Illinois the statute provides: "A public accountant shall not be required by any court to divulge information which has been obtained by him in his confidential capacity as a public accountant."²³ Other states which have adopted similar statutes are: Colorado, Florida, Iowa, Maryland and New Mexico.²⁴

87. Primary or best evidence. Primary evidence is the best evidence of which a case, in its nature, is susceptible.²⁵ If a witness is personally available for testimony, his own direct testimony on a pertinent fact is the best evidence. A writing itself is the primary or best evidence of its contents.

Best evidence rule. Testimony on the contents of a document is inadmissible if the document is available, because the document itself is the best evidence.

Example: A party sues for trespass in cutting down his trees. If he is asked, on direct examination, "Do you own the farm?" the question is objectionable because the deed to the farm is the best evidence. Whenever it becomes necessary to prove the contents of a document, it must be produced or its absence accounted for.

²¹ 70 *Corpus Juris* 377-8.

²² *In re Fisher*, 51 Fed. (2d) 424, 425.

²³ Illinois Revised Statutes, Ch. 110½, sec. 51, as amended July 22, 1943.

²⁴ In 1938, a Committee of the American Bar Association on Improvements in the Law of Evidence recommended "that the legislatures refuse to create any new privileges for secrecy of communications in any occupation; and particularly we recommend against any further recognition of (A) Privilege for information obtained by *Accountants*; (B) Privilege for information obtained by *Social Workers*; (C) Privilege for information obtained by *Journalists*."

²⁵ *Landon v. Morehead*, 34 Okl. 701, 126 P. 1027, 1032.

88. Secondary evidence. If a witness is not personally available for testimony, as where he resides outside the jurisdiction or is dead, secondary evidence may be used; as, in the case of nonresidents, depositions properly taken, or, in the case of a deceased person, testimony by another (not interested in the event) on what such deceased person had said that is competent and material to the issue. If it can be proved that an original writing is lost, destroyed, or physically unavailable, secondary evidence of its contents is admissible, either by producing a copy with proof that it corresponds to the original or by oral testimony on the contents of the original writing.

89. Hearsay evidence. Hearsay evidence is evidence on a fact based, not on the witness's own knowledge or observation of the fact, but on what someone else told him about it. Such evidence is objectionable because it cannot be tested by oath or cross-examination. The witness cannot swear or respond on cross-examination as to the truth of the alleged fact, but only as to the truth of someone having told him about it; for example, in the suit for trespass previously referred to (sec. 87), if the question were asked, "Did you see the defendant chop down the trees?" the answer, "No, but my wife saw it and told me about it" would have to be stricken out as hearsay.

90. Exceptions to hearsay evidence rule. There are numerous exceptions to the hearsay evidence rule, such as confessions, admissions against interest, dying declarations, declarations of a testator (sec. 1167), and so forth. Exceptions of interest to students of business law include: book entries, statistical tables, charts and analyses, and expert testimony.

91. Book entries: the shop book rule. Declarations in the form of book entries are hearsay, but, when made in the regular course of business, they carry some presumption that they reflect the facts they record. Such a presumption is of course *prima facie* only: subject to rebuttal.

This rule of evidence is known as "the shop book rule." It is hedged about by a variety of conditions, some of which have been retained in some states, dropped in others.

For example, books of account were originally admissible in New York only on the following conditions: (a) The party kept no clerk; (b) some of the articles charged had been de-

livered; (c) the books produced were the regular account books of the party and (d) the party could show, by those who had dealt with him, that he kept fair and honest accounts. These conditions have been dropped from the New York statute, which now provides: "Any writing or record, whether in the form of an entry in a book or otherwise, made as a memorandum or record of any act, transaction, occurrence or event, shall be admissible in evidence in proof of said act, transaction, occurrence or event, if the trial judge shall find that it was made in the regular course of any business, and that it was the regular course of such business to make such memorandum or record at the time of such act, transaction, occurrence or event, or within a reasonable time thereafter. All other circumstances of the making of such writing or record, including lack of personal knowledge by the entrant or maker, may be shown to affect its weight, but they shall not affect its admissibility. The term business shall include business, profession, occupation, and calling of every kind."²⁶

92. **Statistical tables.** Standard statistical tables commonly accepted as authentic may be admissible as proof of the facts therein tabulated. Examples are mortality tables, stock exchange quotations, census tables, and so on.²⁷

93. **Charts and analyses.** As an aid to the court, statistical charts and analyses of properly established facts are frequently admitted into evidence, provided a proper foundation is laid for their admissibility, showing how they were prepared, who prepared and checked them, and so on.

94. **Opinion evidence: expert testimony.** Ordinarily, a witness may testify on facts only; his opinions are inadmissible. However, an important exception is furnished in the case of experts, who may either (a) testify to specialized facts only and let the jury draw its own conclusions or (b) testify to specialized facts and give their expert conclusions as well. The latter category includes testimony by doctors, lawyers, certified public accountants, scientists, engineers, merchants with knowledge of values, fingerprint and handwriting experts, and

²⁶ *Civil Practice Act*, sec. 374a.

²⁷ In a recent case, the author introduced in evidence a statistical compilation showing relative popularity ratings of different types of radio programs, taken from a standard statistical publication commonly used in radio advertising.

all persons generally who possess specialized knowledge of the subject under inquiry.

Qualifying the expert. The attorney who puts an expert on the stand must first "qualify" him, that is, ask questions the answers to which will show that the witness is qualified to testify as an expert. A medical expert, for example, will be examined on his education, training, and experience. An accountant will show that he has been duly certified by an official examining board (sec. 1367).

Hypothetical questions. Experts are not called to testify upon the particular facts of a case, but upon their opinion on an assumed state of facts, which must have some relevance to the facts under inquiry. Such testimony is elicited by putting a *hypothetical question* to the witness reflecting the facts which counsel assumes to have been proved on the trial and then asking the expert his opinion on such an assumed state of facts (sec. 1367).

E. Bars to Recovery

95. In general. One may be wronged, yet have no legal remedy if he waits too long to seek redress, or if his suit is inconsistent with prior conduct. In the former case, a remedy may be barred by the *statute of limitations* or by *laches*; in the latter, by *estoppel*.

96. Statute of limitations: definition and object. The "statute of limitations" is really a collection of statutory provisions, fixing a limited period of time within which to sue. Upon the expiration of such period, a cause of action is said to be "outlawed" (sec. 1376). The object of statutes of limitation is to expedite the prosecution of legitimate causes of action and to discourage the bringing of stale claims. The theory underlying such statutes is that it is the general experience of mankind that claims which are valid are not usually allowed to remain neglected, and that a lapse of years, without any attempt to enforce a demand, creates a presumption against its original validity, or that it has ceased to exist. Furthermore, the neglect of a plaintiff is advanced as an additional ground for barring him from enforcing his remedy. The basic principle on which such statutes are most generally justified is that they tend to prevent fraudulent and stale claims from springing up at great distances of time and surprising parties or their representatives, when all the proper vouchers or evidences which might be introduced in defense of the claim, or the facts which might bear upon the claim, have

STATUTES OF LIMITATION
(In Number of Years)

State	Open Accounts	Promis- sory Notes	Contracts		
			Ordinary		Under Seal
			Oral	Written	
Alabama.....	3	6	6	6	10
Arizona.....	3	6	3	6	6
Arkansas.....	3	5	3	5	5
California.....	4(a)	4	2	4	4
Colorado.....	6	6	6	6	6
Connecticut.....	6	6-17(b)	3	6	17
Delaware.....	3	6	3	3	20
District of Columbia...	3	3	3	3	12
Florida.....	3	5(c)	3	5	20
Georgia.....	4	6	4	6	20
Idaho.....	4	5	4	5	5
Illinois.....	5	10	5	10	10
Indiana.....	6	10	6	10-20(d)	10-20(d)
Iowa.....	5	10	5	10	10
Kansas.....	3	5	3	5	5
Kentucky.....	5(e)	15(f)	5	15	15
Louisiana.....	1-3(g)	5	(g)	(g)	(h)
Maine.....	6	6(i)	6	6	20
Maryland.....	3	3	3	3	12
Massachusetts.....	6	6(j)	6	6	20
Michigan.....	6	6	6	6	6(k)
Minnesota.....	6	6	6	6	6
Mississippi.....	3	6	3	6	6
Missouri.....	5	10	5	10	10
Montana.....	5	8	5	8	8
Nebraska.....	4	5	4	5	5(l)
Nevada.....	4	6	4	6	6
New Hampshire.....	6	6	6	6	20
New Jersey.....	6	6	6	6	16-20(m)
New Mexico.....	4	6	4	6	6
New York.....	6	6	6	6	6
North Carolina.....	3	3	3	3	10
North Dakota.....	6	6	6	6	6
Ohio.....	6	15	6	15	15
Oklahoma.....	3	5	3	5	5
Oregon.....	6	6	6	6	10
Pennsylvania.....	6	6	6	6	20
Rhode Island.....	6(n)	6	6	6	20
South Carolina.....	6	6	6	6	20(o)
South Dakota.....	6	6	6	6	20
Tennessee.....	6	6	6	6	6
Texas.....	2-4(p)	4	2	4	4
Utah.....	4	6	4	6	6
Vermont.....	6	6(q)	6	6	8
Virginia.....	3(r)	5	3	5	10

STATUTES OF LIMITATION (Continued)

State	Open Accounts	Promis- sory Notes	Contracts		
			Ordinary		Under Seal
			Oral	Written	
Washington.....	3	6	3	6	6
West Virginia.....	5	10	5	10	10
Wisconsin.....	6	6	6	6	10-20(s)
Wyoming.....	8	10	8	10	10

- (a) Supported by book entries.
 (b) Negotiable and unsealed 6 years; all others, 17 years.
 (c) Under seal, 20 years.
 (d) On contracts, sealed or unsealed, for payment of money, 10 years; on contracts to convey land, 15 years; on contracts sealed or unsealed, other than for payment of money or to convey land, 20 years.
 (e) Due date computed from January 1, following date of purchase.
 (f) On negotiable promissory note not actually negotiated, 15 years; on negotiable promissory note actually negotiated, sealed or unsealed, 5 years.
 (g) Depends on nature.
 (h) Depends on nature, generally 10 years.
 (i) Witnessed notes, 10 years.
 (j) Notes issued by banks, and notes witnessed but not negotiated to third parties, 20 years.
 (k) Except state or municipal bonds or notes, bonds of public officers, covenants in deeds and mortgages, and bonds or notes of public or quasi-public corporations (see sec. 000), when 10-year period applicable.
 (l) Actions on official or statutory bonds, 10 years.
 (m) Action for rent where lease under seal, for debt under sealed obligation for payment of money only, and on sealed award by arbitrators, 16 years; on surety bonds, 20 years.
 (n) Except account concerning merchandise or trade between merchants, 20 years.
 (o) Other than sealed note or personal bond for payment of money only, 6 years.
 (p) On accounts between merchants, 4 years; others, 2 years.
 (q) Witnessed notes, 14 years.
 (r) Except accounts between merchants or partners, when period is 5 years.
 (s) When cause of action accrues within state, 20 years; outside, 10 years.

become obscure. Under such circumstances, such factors as lapse of time, defective memory, death, or removal of witnesses might constitute serious impediments to justice.

97. Statute of limitations: period. The period of the statute of limitations varies with the type of action and the state having jurisdiction. It would be impracticable to list here the numerous variations in the different states or the different types of actions involving different periods in the different states. A tabulation showing the statutory periods in the different states for the most common types of commercial transactions is shown on pages 44-45. Variations as to types of action in a single state (New York) are shown in the table on pages 46-47.

Claims by or against decedent estates. A cause of action in favor of or against a person, which is barred by the statute of limitations at the time of death, is not revived by the fact of death. Some states have adopted statutes which provide in effect that the time which elapses between death and the granting of "letters" (sec. 1187)—during which interval the estate

cannot sue nor be sued—must be added to the statutory period. Other states provide a specific time after death which must be added to the statutory period. In New York, for example, the statute provides that if a person who has a cause of action dies before the statute of limitation expires, and the action is not of a type which dies with the person, the es-

STATUTE OF LIMITATIONS

Maximum Periods for Commencing Suit in New York

Period (years)	Type of Action
40	Action by State, or by grantee from State, affecting real property.
20	Action on judgment of court of record (for example, action in New York on judgment procured in an Illinois court of record). Action on judgment of court not of record but docketed in County Clerk's office (for example, action on judgment in Justice of the Peace Court which has been docketed in County Clerk's office). Action for dower (within 20 years from death of husband).
15	Action by individual to recover real property adversely held (sec. 1041) by another. Action by owner or someone claiming under him to redeem real property from foreclosed mortgage on ground that owner was not barred by foreclosure proceedings.
10	Action for which no other limitation is expressly prescribed by statute. (This includes many actions in equity, such as actions for specific performance, injunction, partition, reformation of an instrument, and so on.)
6	Action on bond or mortgage. Action on contract obligation or liability, express or implied, sealed or unsealed, except judgments (for example, actions on debts and open accounts, breach of contract, promissory notes, checks, and so on). Action to recover on a statutory liability (except a penalty or forfeiture). Action to recover damages for personal injury not arising out of negligence (for example, nuisance). Action to recover chattel ("replevin"). Action to procure judgment on ground of fraud. (Period does not begin to run until discovery of the fraud.) Action to establish will. (Where will has been lost, concealed or destroyed, period does not begin to run until discovery of the facts.) Action on judgment in court not of record, unless docketed in County Clerk's office. Action by or on behalf of corporation against director, officer, or stockholder for an accounting (except as to waste or injury to property), or on fraud, or for penalty or forfeiture.
5	Action to annul marriage on ground of physical incapacity. (Must be commenced within five years from date of marriage.) Action for divorce. (Must be commenced within five years after discovery by plaintiff of offense charged.)

STATUTE OF LIMITATIONS (Continued)

Period (years)	Type of Action
3	<p>Action against sheriff, coroner, constable, or other officer for non-payment of money collected upon an execution.</p> <p>Action against constable upon any other liability incurred while acting in his official capacity, or for omission of an official duty, except an escape.</p> <p>Action upon statutory penalty or forfeiture (except where statute fixes a different limitation).</p> <p>Action against a director or stockholder of a moneyed corporation, or banking association, to recover penalty or forfeiture or to enforce liability created by statute or common law.</p> <p>Action against executor, administrator, or receiver, or against the trustee of an insolvent debtor, to recover a chattel, or damages for the taking, detention, or injury of such chattel.</p> <p>Action for personal injuries resulting from negligence.</p> <p>Action for property damage resulting from negligence or otherwise, except where differently prescribed.</p> <p>Action for violation of right of privacy (for example, for use of a person's name, portrait, or picture for advertising or trade purposes without his written consent).</p> <p>Action by or on behalf of corporation against director, officer, or stockholder to recover damages for waste, injury to property, or for an accounting in connection therewith.</p>
2	<p>Action for assault, battery, seduction, criminal conversation, false imprisonment, malicious prosecution, or malpractice.</p> <p>Action upon a statute for a forfeiture or penalty to the people of the State.</p>
1	<p>Action against sheriff or coroner upon liability incurred by him by doing an act in his official capacity or by the omission of an official duty (except nonpayment of money collected upon an execution, referred to in three-year group, above).</p> <p>Action against officer for escape of prisoner.</p> <p>Action for penalty given to a common informer who will prosecute for same.</p> <p>Action for libel or slander.</p>

tate may bring suit within one year after the person's death, though the statutory period has expired in the meantime. The statute also allows additional time to sue where a prospective defendant dies. (See sec. 1377.)

However, executors and administrators (sec. 1181) need not hold up the administration of an estate until all possible statutory periods shall have elapsed. The law usually fixes a specified period (which may be shortened by advertising) within which creditors must present their claims if they wish to charge an executor or administrator with the assets of the estate. In New York, for example, the statute provides that if creditors do not present claims within a six months' publication period, or, if no notice be published, within seven months from the date letters were issued,

"the executor or administrator shall not be chargeable for any assets or moneys that he may have paid in satisfaction of any lawful claims, or of any legacies, or in making distribution to the next of kin before such claim was presented."

The filing of a claim with an executor or administrator has the same effect as the commencement of suit: the statute stops running forthwith. (See sec. 99.)

Federal statutes: tax delinquencies. In addition to the state statutes of limitations, various statutory periods are provided by Federal law (sec. 1372). For example, the statute of limitations on Federal Income Tax assessments, or for a proceeding in court without an assessment, is three years from the date when the return was filed. The statutory period for a proceeding in court or for a *distrain* (seizure of personal property) after an assessment has been made is six years additional. In case of a false or fraudulent return, or no return at all, the statutory period is "suspended" (does not run).

Actions by or against states. Generally, states may invoke the statute of limitations in suits against themselves, but others may not invoke the statute of limitations in defending a suit brought by a state against them. "Since a state cannot be sued without its consent, a statute of limitations does not begin to run in its favor until it has consented to be sued."²⁸ Thus, if an audit of an estate's assets revealed \$10,000 in Pennsylvania highway bonds which were in default over a considerable period, such period would not run in favor of the State unless it had consented to be sued.

Criminal prosecutions. Generally, time does not run against prosecutions for murder, kidnapping or embezzlement of public moneys. For other felonies, the period varies from three to five years. For misdemeanors, it is generally one or two years from the time the act was committed.

98. When statute of limitations starts to run. The period of the statute of limitations starts to run when a cause of action "accrues" (that is, when one's right to sue begins). This, in a debt action, is the date when the debt is due and unpaid; in an action on contract, when the breach occurs; in a fraud action, when the fraud was or should have been discovered; in a tort action (sec. 29), when the tort is committed.

Promissory notes. In an action on an ordinary promissory note (sec. 268) due at some future time, the statute starts to run, not from the date of the note, but from the date of its maturity.

Demand notes. A demand note (sec. 267) is due forthwith. The statute of limitations begins to run from the date of the note. This is the prevailing rule throughout the country.²⁹

Open accounts. "An open account, within the meaning of the various statutes of limitation, is one in which some term of the contract is not set-

²⁸ 59 *Corpus Juris* 320.

²⁹ 10 *Corpus Juris Secundum* 744.

tioned by the parties, or where there are current dealings between them, and the account is kept open because of some contemplated future dealings, whether the account consists of one or many items. The account must be mutual, open, and current between the parties in order that it may fall within the purview of the statute, and transactions treated by the parties as distinct from each other do not constitute an open running account.”³⁰ In an action brought to recover a balance due upon an open account, the statute starts to run *from the date of the last item of the account* at the point where the continuity of the account has been broken and a final balance may be said to be due.

What constitutes break in continuity of account. A demand for payment constitutes a break in the continuity of an account current. In an action to recover a balance due upon a mutual open and current account, reciprocal demands between the parties for payment of the balances allegedly due are necessary to constitute a break in the continuity of such account, upon discontinuance of the usual transactions of business. Only then is the account so closed as to start the statute of limitations running. When that happens, the last item in the account draws to itself all prior items, and these will be barred only when the statute has run *against the last item*.³¹

A demand may take any form showing an intent to discontinue the account unless payment is forthcoming. For example, an oral demand, if properly proved, would be sufficient. So, of course, would a written demand. The commencing of a lawsuit would constitute such a demand. A statement showing the amount due, followed by refusal to extend credit until the balance is paid, would likewise be the equivalent of such a demand.

99. Suspending the statute of limitations. Factors which suspend the statutory period are: (a) disability of the plaintiff to sue (such as infancy or insanity) and (b) absence of the defendant from the jurisdiction so that he is not amenable to process. In the former case, it would be unjust to count time against one unable to sue, and in the latter, to wipe out a debt in favor of one who placed himself in a position where he could not be sued.

Claims by or against decedent estate. The filing of a claim with an executor or administrator suspends the running of the statute until the claim is finally determined in the surrogate's or probate court.

Example: A claim for medical services was filed with a New York executor. The executor rejected the claim. Seven years later the claimant sought payment by filing a petition for compulsory accounting. The executor contended that the claim was outlawed by the six-year statute of

³⁰ 37 *Corpus Juris* 768-9.

³¹ 37 *Corpus Juris* 865-6; *Green v. Disbrow*, 79 N.Y. 1, 13, cited with approval in *Minion v. Warner*, 238 N.Y. 413, 418-9; *Adams v. Olin*, 140 N.Y. 150.

limitations, but the court sustained the validity of the petition: the filing of the claim had suspended the statute.³²

100. Tolling the statute of limitations. To "toll" the statute of limitations is to start it running all over again, though the entire period or some part of it has already run. Factors which will toll the statute are:

A written acknowledgment of the debt, from which the inference of a new promise to pay may be drawn. This revives the statute for the full period, starting with the date of the acknowledgment. But such acknowledgment must contain nothing inconsistent with the debtor's intention to pay. If it is accompanied by a refusal to pay, or by the contention, "The claim is outlawed, so you can't collect," or a declaration of unwillingness or inability to pay, or an offer to compromise, it will not toll the statute. The effect of a written acknowledgment in reviving the debt is not dependent on the presence or absence of consideration (sec. 1378).

Payment on account, either of principal or interest, from which a promise to pay the debt may be implied. Thus, payment of interest by the maker of a promissory note (sec. 280) tolls the statute anew against the maker³³ but *not against an indorser*, unless he has authorized or consented to such payment.³⁴

101. Claims not barred by statute of limitations. Certain claims are not subject to the statute of limitations, including, among others:

(a) An action upon a bill, note or other evidence of debt circulating as money;

(b) An action brought by the Federal Government, or by a state, except where the government specifically prescribes a time limit (see page 46, forty-year period);

(c) Enforcement of an existing property right or lien (sec. 643). For example, if I own a diamond ring, your possession of it for more than six years will not defeat my title; or if I pledged it with you more than six years ago, you would still have the right to foreclose.³⁵

(d) Federal Income Tax delinquencies, where a false or fraudulent return, or no return at all, is filed (sec. 97).

(e) Prosecutions for murder, kidnapping, or embezzlement of public moneys (sec. 97).

³² *Matter of Schorer's Estate*, 272 N.Y. 247.

³³ *Stevens v. Lord*, 84 Hun 353, aff'd 146 N.Y. 398.

³⁴ *McMullen v. Rafferty*, 89 N.Y. 456.

³⁵ *Conway v. Caswell*, 121 Ga. 254, 48 S.E. 956; *Pollack v. Smith*, 107 Ky. 509, 54 S. W. 740; *Townsend v. Tyndale*, 165 Mass 293, 43 N.E. 107; *U.S. v. Mercantile Trust Co.*, 213 Pa. 411; *Connecticut Mut. L. Ins. Co. v. Dunscomb*, 108 Tenn. 724; *Goldfrank v. Young*, 64 Tex. 432; *Roots v. Mason City Salt Min. Co.*, 27 W.Va. 483.

102. *Laches*. Where a person delays in bringing suit, but the delay does not equal the period of the statute of limitations, a court of equity may yet hold that the claimant was guilty of unreasonable delay in pursuing his remedy, and may thus bar the claimant by reason of such delay, or *laches*.³⁶ To plead *laches*, one must show that he has suffered some prejudice by the delay.

103. *Estoppel*. There are many cases where one wronged is not guilty of delay in seeking redress, yet is barred or *estopped* from bringing suit by reason of previous conduct. Estoppel thus operates as a bar to prevent a person from taking a position inconsistent with one he has previously taken, where such inconsistency will work an injustice to an innocent person who relied on the position previously taken.

Three kinds of estoppel are: (1) equitable estoppel, (2) estoppel by judicial record, (3) estoppel by deed.

(1) *Equitable estoppel* (*estoppel in pais*) is one raised against a person who, having taken a given position (by assertion, denial, or failure to speak when there was a duty to speak), will not be allowed to reverse his position in such a way as to injure a person who relied on the position previously taken. Examples are: agency by estoppel (sec. 553), partnership by estoppel (sec. 646) and corporation by estoppel (sec. 751).

(2) *Estoppel by judicial record* exists where a person sues on one theory on which a judgment is entered and later seeks to proceed on another theory contrary to the judgment. A judicial record "imports absolute verity, and all parties thereto are estopped from denying its truth."³⁷ For example, after a judgment is rendered, the facts established thereby may not be denied by any party to the action, except by way of appeal. Other examples: admissions by a party in court,³⁸ agreed facts upon the basis of which a trial is had, stipulations of counsel, affidavits made by a party to a judicial proceeding (which the affiant or party making the affidavit is not later allowed to deny).

(3) *Estoppel by deed* exists where a person recites certain facts, assurances or covenants in a deed, which he later seeks to dispute.

Example: I sell you a house, which I do not own. I give you a full covenant and warranty deed, in which I warrant, among other things, that I have title. You take possession. Later, I obtain actual title from the true owner, who gives me a deed so that I become the true owner. I then seek to eject you on the ground that I am now the true owner, and you

³⁶ *Steinhauer v. Botsford*, 327 Ill. App. 296, 64 N.E. 2d 187.

³⁷ 21 *Corpus Juris* 1064.

³⁸ *New Jersey Suburban Water Co. v. Town of Harrison*, 122 N.J. Law 189, 3 A.2d 623.

are not. My ejectment proceedings would fail: I would be estopped by my prior deed from now disputing what I formerly warranted, namely, that when I sold you the property, I was then the true owner.

A person who invokes the doctrine of estoppel must show that he has been misled by the prior representation and that he will be damaged if the person who made it is permitted to reverse himself.³⁹

Questions and Problems for Review

1. What is municipal law? *NY June 1924 (15)*
2. Define "common law" and briefly differentiate it from statutory law. *AI Nov 1934 (9)*
3. Distinguish between the jurisdiction of a Court of Law and that of a Court of Equity. *NY Nov 1929 (8)*
4. The securities act of 1933 provides that in certain cases of untrue statements or omissions of statements which should have been made, certain persons "may, either at law or in equity, in any court of competent jurisdiction, sue" an accountant who has prepared or certified any part of the registration statement.
 - (a) Explain what is meant by equity and how it differs from law.
 - (b) What is the most common remedy obtainable only in equity? *AI May 1934 (9)*
5. What in your opinion is the function of the accountant in connection with questions of law? To what extent, if at all, should an accountant advise clients with respect to matters in which the principal point involved is a question of law? *NY Jan 1926 (15)*
6. Define forgery in the third degree as pertaining to books of account. *NY June 1917 (10)*
7. A cashier is found to be short in his accounts by the auditor. For each of the assumptions mentioned below, state with what crime he is chargeable and whether he may be tried on each count separately or together.
 - (a) At one time he took \$360, the proceeds from a note payable not entered on the books.
 - (b) At another time he took \$610, and covered this act by inflating certain expense accounts. *NY Oct 1933 (9)*
8. A cashier is found to be short in his accounts and admits the fact but is unable to explain the deficiency. With what crime, if any, is he chargeable? *NY June 1917 (9); NY Jan 1924 (9)*
9. (a) Under what powers given to it by the Constitution of the United States did Congress enact the following legislation: Securi-

³⁹ *Mitchell v. Friedlander*, 246 Ala. 115, 19 So. 2d 394; *Frost Motor Co. v. Pierce*, 72 Ga. App. 447, 33 S.E. 2d 910; *Corn Belt Bank v. Baker*, 190 Okl. 278, 122 P. 2d 989.

ties Act of 1933, Corporate Bankruptcy Act, Securities Exchange Act of 1934?

(b) Describe briefly the purpose of each of these acts. *NY Nov 1934 (12)*

10. (a) How, in general, would you draw the line between interstate business and intrastate business?

(b) Are citizens of each state entitled to the privileges and immunities of citizens in the several states? (State the authority for your answer.)

(c) Is a corporation a citizen to which your answer to (b) applies? *AI Nov 1933 (4)*

11. A new state road is being constructed between Cardiff and Monk's Hill. Land for this road was acquired by the exercise, on the part of the state, of the right of eminent domain. In what ways could the compensation to the owners of the property taken be determined? *NY Apr 1933 (8)*

12. As to relevance, into what three classes may evidence be divided? Define the three classes. *NY June 1917 (1)*

13. Give a brief definition of *prima facie* evidence of a debt. *NY Jan 1923 (8)*

14. A bookkeeper, having acquired certain confidential information from his employers, is called as a witness in an action against his employers and questioned with regard to certain communications. He refuses to answer on the ground that these communications are of a confidential nature. Is he legally right in his position? Explain. *NY Jan 1917 (4)*

15. Are books of account of the plaintiff conclusive evidence in proving an account against a customer? Are the accounts of a defendant in an action admissible as evidence to prove the plaintiff's case? Which books of account are admissible as evidence and which are not? *NY Jan 1924 (8); NY June 1917 (3)*

16. What principles of law govern the acceptance in court of accounting books and records as evidence in civil actions where proof of having entered into certain business transactions is essential? *NY Apr 1933 (13)*

17. What is a statute of limitations and what is its object? *AI May 1929 (12)*

18. When does a demand note become due and when is a promissory note outlawed in this state? *NY June 1919 (13)*

19. What legally constitutes a break in the continuity of an account current when there has been a discontinuance of the usual transactions of business? *NY June 1921 (8)*

20. When is an open account barred by the Statute of Limitations? What acts of the debtor will remove this bar? *NY Nov 1930 (4)*

21. Does the payment of interest by the maker of a demand note start the period of limitation running anew as against him? Does such payment of interest by the maker start the period of limitation over again with regard to the liability of the indorser of the note? *NY Jan 1924 (4)*

22. In making up an inventory for an executor, you find among the securities, constituting the corpus of the estate, \$10,000 in 6% bonds issued by the State of Pennsylvania, the proceeds of which had been used for highway improvement. Your examination of these securities develops the fact that the interest on the bonds was in default and had remained so for considerably over a year. What reply would you make to the executor in answer to his question, "Can payment of these coupons be enforced? If so, by whom?" In giving your answers, state also the legal principles involved. *NY June 1922 (8)*

23. Explain what is meant by the doctrine of estoppel. Name three kinds of estoppel. *NY May 1926 (2)*

CHAPTER II

Contracts

104. **Scope of this chapter.** In this chapter we shall consider the formation* and requisites of a contract, the form in which contracts may be executed, the operation and effect of contracts, and the manner in which contracts may be discharged. We shall also consider briefly how contract disputes may be arbitrated.

A. Formation and Requisites*

105. **Definition and nature.** A contract is defined as an agreement upon sufficient consideration to do or refrain from doing some lawful thing. The agreement must create an obligation. This obligation takes the form of a binding promise, expressed in words or implied from conduct. To be binding, the promise must have been given in exchange for something of value, such as an act (paying money, delivering merchandise, rendering service), or a promise to do the act, or else the giving up of some right, privilege, or benefit. Such a thing of value is termed *consideration* (sec. 143).

106. **Requisites of contract.** There are certain requisites which every contract must have; if it lacks any one of these, it is void. These requisites are: *mutual assent*, *parties* with capacity to contract, *consideration* and *valid subject matter*. To these, the additional elements of *time* and *form* are sometimes added.

Example: In consideration of the sum of \$250 in hand paid by Richard
[*Consideration*]

Green to Harry Brown, receipt whereof is hereby acknowledged, it is
[*Parties*]

hereby mutually agreed that Harry Brown is to ship and deliver to Rich-
[*Mutual Assent*]

ard Green at his said address, 1,000 pounds of Rio coffee, superfine blend,
[*Subject Matter*]

not later than 12 o'clock noon, June 1, 1948.

[*Time*]

The *form* of the contract given in the above example may be oral or written.

107. Mutual assent. Mutual assent consists of two things: an offer and an acceptance. The offer itself must conform to certain requisites. The acceptance must meet the offer exactly, otherwise the assent is not mutual: no contract results.

108. Requisites of offer. An offer, to serve as the basis for a contract, (a) must be seriously intended as such, (b) must be communicated to the person who is to accept it, and (c) must be definite and certain.

109. Offer must be intended as such: invitations to trade. An offer must be intended as the basis of a valid obligation. This excludes offers involving social functions, such as theater or dinner parties, and so on. It also excludes "invitations to trade." Price lists, circular letters and most advertisements are construed as invitations to trade.¹ So are most offers to sell an indefinite quantity of merchandise.

Examples: (1) A storekeeper contracts with a newspaper to publish an advertisement of its merchandise, including items priced at \$15 each. The price is erroneously published as \$5 instead of \$15. The storekeeper, refusing to pay for the advertisement, asserts a claim against the newspaper for losses sustained through having to sell his articles at \$5 instead of \$15. The claim is unfounded. The storekeeper was not obliged to accept such losses. His advertisement did not constitute an offer but only an invitation to trade.

(2) A stationery company writes to a certified public accountant: "We have quite a few pads of slightly defective but completely usable analysis paper which we now offer you at 45 cents per pad." (See sec. 1384.)

110. Offer must be communicated. One cannot accept an offer of which he has no knowledge.

A *particular offer* is one made to a particular person or persons. An offer made to one person cannot be accepted by another.

A *general offer* is one addressed to the public, as by a newspaper advertisement, poster, bulletin, and so on. Offers of reward are frequently thus made. A general offer of reward for the doing of an act is not accepted where one does the act without knowledge of the offer.

Example: Carter publishes an offer of reward for information leading to the discovery of the murderer of his brother. Martin, without knowledge of the reward, gives the desired information. Later, upon learning of the reward, he sues to recover it. His suit must fail.

111. Signing without reading. If an offer is brought to the attention of an offeree in such a way that a person of ordinary

¹ *Nickel v. Theresa Farmers Coop. Ass'n*, 247 Wis. 412, 20 N.W. 2d 171.

intelligence would be presumed to have knowledge of it, communication of such an offer will be presumed. Hence, if one accepts a written offer, as by signing a paper, and later claims he had no fair opportunity to read it, he is bound by his acceptance and cannot shelter himself behind the defense of ignorance, even if in fact he did not read the offer he accepted.² Inability to read what one signs because of defective eyesight is no defense if one signs notwithstanding. (See sec. 1385.)

Signature procured by fraud. If a signature is procured by fraud, the offeree is not bound. Hence, a contract procured by trickery is unenforceable.

Example: In *Wilcox v. American Telephone & Telegraph Co.*,³ a farmer was induced by the Company's agent to sign a paper represented to be a receipt. In reality the paper was a document giving the Company a right to erect poles on the farmer's land. The court refused to recognize the document because of the trickery, though the farmer had an opportunity to read it. Had the farmer signed through ignorance, but without trickery, he would have been bound.

Inconspicuous type. If an offer contains terms so inconspicuous that the average person would be unlikely to see them, such terms may be presumed not to have been communicated. Matter printed in small type on the back or at the foot of a letterhead or billhead, or in the margin of office stationery, may be deemed excluded because insufficiently communicated, unless attention is called to it in the body of the writing.

112. Offer must be definite and certain. Vague and indefinite offers cannot furnish the basis for acceptance; otherwise it would be difficult to determine whether a breach was committed.

Examples:

(1) *B* hires *A* on a salary of \$40 a week plus a "fair share of the profits of the business."

(2) A buyer agrees "to give the 'R. S.' brand cement the preference" in his sales for the year 1948, and in consideration thereof, the seller agrees "to sell said brand of cement to the first party during the year 1948 at the price of 95 cents a bbl. f.o.b. Haverstraw, New York." Each of these proposals, viewed as an offer, is too vague and indefinite to furnish the basis for an acceptance.

² *Griffiths v. Brooks*, 227 Iowa 966; *McCubbins v. Morgan* (Miss.) 23 So. 2d 926; *Morrison v. Roberts*, 195 Ga. 45, 23 S.E. 2d 164; *Prewitt v. Estate Bldg. & Loan Ass'n*, 288 Ky. 331, 156 S.W. 2d 173; *Fontenot v. Coreil* (La.), App., 2 So. 2d 97; *State ex. rel. St. Louis Car Co. v. Hughes*, 348 Mo. 125, 152 S.W. 2d 193; *Mannion v. Hudson & M. R. Co.*, 125 N.J. Law 606, 17 A. 2d 546, aff'd 127 N.J. Law 230, 21 A. 2d 735; *Mullen v. John Hancock Mut. Life Ins. Co.*, 150 Pa. Super. 323, 28 A. 2d 456; *Pickett v. Riley* (Tex.) 149 S.W. 2d 990.

³ 176 N.Y. 115.

113. Form of offer. Offers may be oral or written. Oral offers are those made by word of mouth: face to face, by telephone or by radio. Written offers are those made by letter, telegram, advertisement, or other written medium, as by presenting a formal contract for signature.

114. Disposition of offer. Three things may happen to an offer: It may be *revoked*, *rejected* or *accepted*. We shall consider the effect of each of these upon the offer.

115. Revocation of offer. An offer may always be revoked (withdrawn) before it is accepted, with three exceptions: (1) In all states a promise to hold an offer open for a given time (namely, an *option*) is binding provided the promise is based on consideration; (2) in some states (New York, for example) a *written* option is binding without consideration (sec. 148); and (3) in a few states (reflecting the common law rule) an option under seal is binding because a seal, under the common law, imports consideration (see sec. 148).

Example: A offers to sell B three dozen hats of a given description, at a given price, on given terms. A also agrees that the offer is to remain irrevocable for two weeks. The offer may be revoked at any time before it is accepted, with the exceptions noted above.

An offer may be revoked in the following ways:

Expressly. If I have made you an offer and no longer wish to be bound by it, I owe you the duty of communicating my revocation to you. But whether I have communicated the revocation or not, if you learn (no matter how) that the offer is no longer open, you cannot accept it.⁴ General offers may be revoked in the same way they were made. For example, today I advertise a \$50 reward in a newspaper for the return of a lost ring, and tomorrow I advertise a revocation in the same newspaper; you see the first advertisement but not the second, then find the ring. You cannot collect the reward.

By lapse of specified time. When a time is fixed for acceptance, the offer is deemed revoked by lapse of such time. However, with the exceptions noted, one may revoke an offer even before expiration of the time fixed for acceptance.

By lapse of reasonable time. An offer automatically lapses if not accepted within a reasonable time. What constitutes a reasonable time depends on the circumstances.

By death or insanity. An offer (unless first accepted) lapses upon death or insanity of the offeror or offeree. There can be no offer without a mind behind it.

⁴ *Masonic Temple v. Ebert*, 199 S.C. 5, 18 S.E. 2d 584.

116. Rejection of offer. An offer is extinguished by rejection. It cannot thereafter be accepted unless renewed.

Examples: (1) *Flat rejection:* *A* offers to buy 100 barrels of flour from *B* at \$15 a barrel on twenty days' credit. *B* refuses.

(2) *Rejection by counteroffer:* *A* offers to buy 100 barrels of flour from *B* at \$15 a barrel on twenty days' credit. *B* first replies, "I accept your order and will ship the goods, *but on ten days' credit*"; and later, after *A* receives this letter, *B* writes again, "I have reconsidered, and will allow twenty days' credit. Am shipping the goods." *A* need not accept the goods. *B*'s first counteroffer rejected *A*'s offer.

117. Acceptance. Acceptance of an offer constitutes a meeting of minds and results in a contract. But the acceptance must be unqualified, and must conform with the terms of the offer. Thus, if the offer specifies that acceptance must be made in some particular way, as by mail, telegraph, cable, and so on, it must be made in that way.⁵ If the offer specifies no mode of acceptance, it may be accepted in any way, provided the acceptance is actually communicated to the offeror.

118. Offer and acceptance by mail, telegraph, cable, and so on. Offers, acceptances, revocations and rejections by mail, telegraph, cable, and so on, can be understood better if we consider the following hypothetical situations, in which *A* and *B* have no way of intercommunication except by messenger:

(a) *A* sends an offer to *B* by messenger, and before *B* accepts, *A* sends another messenger to revoke the offer. The second messenger arrives with his revocation before *B* accepts. The revocation is communicated—the offer is withdrawn—*B* can no longer accept.

(b) If *B* gives the first messenger an acceptance while *A*'s second messenger is on his way with a revocation but before he actually delivers it to *B*, there is a contract, and the revocation, when it arrives, is too late.

(c) If *A*'s first messenger departs right after delivering the offer without waiting for an acceptance and *B* sends his own messenger to accept the offer, the acceptance is not effective until it is actually delivered to *A*; and if *B*'s messenger tarries on the way or loses the message and *A* in the meantime sends his messenger back to *B* with a revocation, there can be no acceptance after the revocation is delivered: *B* must look to his own messenger for redress.

(d) If *A*'s offer stipulates that it can be accepted only by delivering an acceptance to *A*'s messenger, *B* cannot accept through a different messenger.

(e) If *A*'s offer stipulates that he is not to be bound by an acceptance

⁵ *Folz v. Evans*, 113 Ind. App. 596, 49 N.E. 2d 358.

unless and until *A*'s messenger returns and delivers the acceptance to him, there is no contract until the acceptance is actually brought back to *A* by *A*'s messenger.

The foregoing hypothetical situations may now be adapted to offers by mail, wire or cable. If I employ any of these agencies to communicate an offer and if I do not prescribe a particular mode of acceptance, you may accept by the same or any other agency. If you accept by the *same* agency (*my* agent), the acceptance becomes effective when it is delivered to such agency,⁶ that is, when it is mailed or delivered to the telegraph or cable company, as the case may be. If I *mail* you an offer and you *wire* an acceptance, I am not bound if your wire is lost in transmission; you must look to *your* agent for redress. An offer by mail may be withdrawn or rejected so long as it has not already been thus accepted.

Examples:

(1) *A* wires an offer to *B* at 9 A.M. which is received by *B* at 11:15 A.M. *B* wires an acceptance at 12:45 P.M. which reaches *A* at 4:15 P.M. At 2 P.M., however, *A* had wired a revocation which reached *B* at 3 P.M. Is there a contract?

There is. *A*'s revocation was communicated two hours and fifteen minutes after *B*'s acceptance.

(2) *A* in New York makes an offer by mail to *B* in Buffalo. *B* posts an acceptance and later wires a withdrawal of the acceptance. *B*'s wire reaches *A* before the letter. Is there a contract?

Yes. *B*'s wire, though it reached *A* first, could not destroy the contract which arose on posting the acceptance (unless *A* acquiesced in *B*'s withdrawal).

(3) *A* in New York air mails an offer on Monday to *B* in San Francisco, which *B* receives on Tuesday morning. Immediately on receiving *A*'s offer, *B* sends a night letter accepting *A*'s offer, which reaches *A* on Wednesday. On Tuesday afternoon, however, *A* wires *B* withdrawing his offer. That wire reaches *B* Tuesday night, ten hours after *B* sent his night letter. Is there a contract?

No. When *B* accepted by night letter (telegraph company) instead of by mail, he chose his own agent, or agency, to deliver his acceptance, and such acceptance was not complete until it actually reached *A*. Had *B* accepted by air mail, or even by ordinary mail, acceptance would have been complete on posting. (Had *A* specified that acceptance must be by air mail only, there could have been no acceptance at all except by air mail.)

⁶ *L. & E. Wertheimer v. Wehle-Hartford Co.*, 126 Conn. 30, 9 A. 2d 279; *State of Ohio ex rel. Squire v. Eubank*, 295 Mich. 230, 294 N.W. 166; *Dick v. Vogt*, 196 Okl. 66, 162 P. 2d 325; *McKinney v. Croan* (Tex.) 188 S.W. 2d 144, 145.

(4) On October 10th *A* mails an offer to *B* to sell 150 tons of Steel Filings, Second Grade, at \$66.50 a ton, "subject to actual receipt of your acceptance at this office by mail not later than the 21st inst." *B* receives this offer on October 12th. He mails an immediate acceptance which, however, is lost in the mails. Is there a contract?

There is not. The offer required actual receipt of acceptance.

Acceptance after rejection. On principle, the offeree's rejection, like his acceptance, should become effective on delivery to the offeror's agency. This, however, is not the rule. "Rejection by mail or telegram does not destroy the power of acceptance until received by the offeror but limits the power so that a letter or telegram of acceptance started after the sending of the rejection is only a counteroffer unless the acceptance is received by the offeror before he receives the rejection."⁷

Example: *A* makes *B* an offer by mail. *B* immediately mails a letter of rejection. Then, within the time permitted by the offer, *B* accepts. This acceptance creates a contract if received before the rejection.

119. Auctions. Auctions are governed by the following rules relating to offer and acceptance: the auctioneer merely calls for offers; the bidder makes the offer; and acceptance is complete when the hammer falls.

120. Silence no acceptance. An offeror cannot compel an offeree to speak or act, on penalty of construing silence as acceptance.

Example: A stationery store voluntarily delivers a package of analysis paper at the office of an accountant, with a sealed letter stating that unless the paper is returned in 10 days the accountant will be deemed to have accepted it at the price stated. The package and letter are accepted by the accountant's clerk as a matter of routine. Assuming that there have been no prior transactions in which the accountant has accepted and used paper in this manner (which might create an inference of acceptance based on prior conduct), the accountant is not liable for the paper; neither is he required to answer the letter or return the package. (Of course, if the accountant reads the letter and uses the paper, he voluntarily accepts the terms stated in the letter.)

121. Agreements to agree. An agreement to reach an agreement is no agreement at all. Mutual assent must be voluntary. The law cannot *compel a voluntary* assent. Hence an agreement to agree has no force in law.

122. Agreement to formalize agreement. Where the parties have informally reached substantial agreement on terms with the intention of embodying such agreement into a formal contract, the informal agreement is binding though the formal

⁷ *Restatement of Law of Contracts*, sec. 39.

agreement is never drawn up or executed.⁸ To this rule, however, there are several exceptions:

(a) Where parties do not intend the informal agreement to be binding unless and until the formal agreement is executed.

(b) Where the informal agreement is insufficient in law, as in the cases governed by the statute of frauds (sec. 182).

An informal writing, if sufficiently definite as to terms, may constitute a binding contract though it provides for a subsequent formal writing.

Example: A document entitled "Articles of agreement," duly executed, states that the parties have agreed to execute a formal lease of specified premises, for a specified term, at a specified rental; the lease to contain "the usual and proper covenants" as to possession, surrender and delivery, warranty, re-entry and so on, "in brief, all the usual and formal clauses to the mutual satisfaction of the parties." Such writing is binding though it is never followed by a formal lease. It expresses with sufficient definiteness the intention of the parties. Since mutual assent is substantially complete, the expression "to the mutual satisfaction of the parties" obviously refers to the choice of mutually satisfactory words to express their assent.

123. Reality of assent. Mutual assent must consist of a real meeting of minds. Factors which may mar or even destroy the reality of mutual assent are *fraud*, *mistake*, *duress*, and *undue influence*.

124. Fraud: defined. Both common law and equity have hesitated to define fraud, for fear, as the court declared in *Stonemets v. Head*,⁹ that "were courts to cramp themselves by defining it with a hard-and-fast definition, their jurisdiction would be cunningly circumvented at once by new schemes beyond the definition." Nevertheless the cases teem with definitions of fraud. In the law of contracts, fraud is defined as a "reckless or intentional misrepresentation of material fact inducing one to contract to his injury."¹⁰

125. Classifications of fraud. There are numerous classifications of fraud. These are by no means universally accepted as meaning the same thing in different jurisdictions. Among

⁸ *Cowin v. Salmon* (Ala.), 13 So. 2d 190; *Clarke v. Fiedler*, 44 Cal. App. 2d 838, 113 P. 2d 775; *Socony-Vacuum Oil Co. v. Elion*, 126 Conn. 310, 11 A. 2d 5; *Micheletti v. Fuggitt*, 61 Nev. 478, 134 P. 2d 99; *Moran v. Fifteenth Ward Building & Loan Ass'n*, 131 N.J. Eq. 361, 25 A. 2d 426; *North American Managers v. Reinach*, 177 Va. 116, 12 S.E. 2d 806.

⁹ 248 Mo. 243.

¹⁰ 17 *Corpus Juris Secundum* 504.

the more common classifications and distinctions are the following:

(a) *Fraud in the factum* (also known as fraud in the *procurement*, fraud in the *execution*, and fraud in the *inception*), which is said to exist when, by trickery, a person is made to sign a different instrument from the one intended, so that there is really no meeting of minds at all. The instrument in such case is a nullity; the contract is void, not *voidable* (see sec. 176). For an example, see section 111.

(b) *Fraud in the treaty* (also known as fraud in the *inducement*, or *antecedent* fraud) is fraud occurring during the negotiations which precede the making of the contract. The contract itself is the one intended to be made, but the reality of assent is marred by the antecedent fraud. Hence the contract is valid, but *voidable* at the option of the defrauded party.

(c) *Actual fraud* (as distinguished from *constructive* fraud) is fraud based on a misrepresentation of fact with intent to deceive.

(d) *Constructive fraud* (also known as *legal fraud*, or *fraud in law*) is based, not on a misrepresentation of fact, but on a false violation of duty. It exists—regardless of intent to deceive—as a matter of law declared by the court, not as a matter of fact determined by a jury. It frequently results from violation of a fiduciary relationship.

Examples:

(1) It becomes desirable for the XYZ Corporation to buy certain oil wells. The directors form a separate corporation (in which they are secretly interested) which buys the oil wells and resells them at a profit to the XYZ Corporation. Such conduct of the directors constitutes constructive fraud.

(2) A depositor having a balance of \$22,505 with a trust company lost his memory following an illness. An official of the trust company, knowing all the facts but concealing his official position, induced the depositor to contract to pay \$10,000 for revealing the location of the deposit. This, said the court, was constructive fraud.¹¹

(e) *Actionable fraud*. Regardless of the numerous forms which deception may take, the broad term "actionable fraud" applies to misrepresentation as distinguished from breach of duty. For actionable fraud, certain elements are essential and certain remedies available.

126. Elements of actionable fraud. The elements of actionable fraud are: (a) misrepresentation, (b) its materiality, (c) knowledge of its falsity or ignorance of its truth, (d) intent that it should be acted on and (e) rightful reliance by the defrauded party (f) to his damage or injury.

(a) *Misrepresentation in general*. Misrepresentation may take the form of words, conduct, or silence when there is a duty to speak. In the latter case it is known as *concealment*.

¹¹ *Gierth v. Fidelity Trust Co.*, 93 N.J. Eq. 163, 115 A. 397.

Words. "The plainest case of a false representation is the telling of a deliberate lie. . . . A representation need not be a direct lie in order to constitute actionable fraud; the false representation may consist in a deceptive answer, or any other indirect but misleading language."¹²

Conduct. "Actions speak louder than words." The court has held that a nod, a wink, a shake of the head or a smile may constitute fraud under certain conditions.

Examples: (1) selling a crate of ostensibly high quality peaches, with rotten fruit hidden underneath; (2) covering up defective material or workmanship by the use of plugs, putty, paint, and so on; (3) turning a log of mahogany over to hide a hole in it; (4) turning back an automobile speedometer; (5) pointing to a high number on a typewriter (suggesting recent manufacture) which has been affixed by a dealer to a secondhand machine.

Silence (concealment). Mere silence does not constitute concealment unless there is a duty to speak. Ordinarily, where persons deal at arm's length, there is no duty to speak except where a deliberate failure to answer a question gives a misleading impression or where one under no duty to speak volunteers a misleading statement.

Examples:

(1) *A* induces *B* to transfer title to certain lost sheep which *A* knew had been found, but *B* did not. Had no questions been asked nor answers given, there would have been no fraudulent concealment. *A* volunteered the opinion, however, that the sheep would never be found. The court held that *A* was guilty of fraud.¹³ (Had *B* stated, "I suppose those sheep will never be found," *A*'s failure to reply would likewise have amounted to fraudulent concealment.)

(2) *B*, a violin expert, buys a famous old violin from *A* (who has no knowledge of its true value) at a price far less than its value. If *A* asks no questions and *B* volunteers no representations, the transaction must stand; but if the buyer makes a misleading statement, the transaction is tainted with fraud.¹⁴

Where parties deal, not at arm's length, but in relationships involving faith and confidence (principal and agent, attorney and client, partner and copartner, and so on), full disclosure is required whether questions are asked or not: failure to speak amounts to concealment.

(b) *Materiality.* The misrepresentation must be material. The test is this: Did the misrepresentation induce the contract, or, conversely, would the contract have taken place without it?

(c) *Knowledge of falsity, or reckless ignorance of truth,* which courts refer to as "scienter," is essential to hold a person liable for fraud, but knowledge is not essential as a basis for avoiding a contract. Knowledge of falsity, calling for proof of a state of mind, is often difficult to prove; but the law will presume knowledge where one has the means of knowing.

¹² 137 *Corpus Juris Secundum* 225.

¹³ *Bench v. Sheldon*, 14 Barb. 66.

¹⁴ *Long v. Krause* (Nebr.), 181 N.W. 372.

Example: The director, vice president, and general manager of a casualty company, who was also half owner, to induce plaintiff to buy his stock, furnished a written statement of the company's financial position showing a surplus of \$112,201.34. Relying on the statement, plaintiff bought the stock. Later, an examination by the state insurance department showed, as of the date of the prior statement, a deficit of \$47,943.01 instead of the reported surplus. The difference lay in the reserve for outstanding claims. Defendant, on the trial, offered no proof of how he had determined the reserve. From all the circumstances, a jury would be justified in concluding that defendant had knowledge of the falsity of his statement.

Recklessness of the truth is equivalent to fraud. "One who . . . states a fact to be true when he has no knowledge on the subject, and thus misleads the other to his injury, is as much liable in law as for a fraud, as if he had wilfully misstated a fact to be true when he knew it to be false."¹⁵

Honest error. Misrepresentation based on honest and reasonable error is not fraudulent, and the person who makes it is not liable for fraud, though a contract based on it may be avoided or rescinded, as in the case of mutual mistake (sec. 132).

Example: The vice president of a corporation signed a statement prepared in the usual course of business by a trusted employee. The truth or falsity of the statement was unknown to him, but he assumed it was true. Actually, it was false. The court held that the vice president was not so reckless as to be personally liable for the misrepresentations contained in the statement.¹⁶ A contract based on such misrepresentations, however, may be avoided or rescinded.

(d) *Intent to deceive.* The representation, to be actionable, must have been made with intent to deceive the other party and cause him to act on it. This excludes false statements made in jest or casual representations made without intent to induce action.

(e) *Rightful reliance.* There can be no deception where there is disbelief; neither can one claim injury from a misrepresentation on which he did not rely. Under the earlier decisions, the right to rely depended on the exercise of common prudence and diligence in view of all the circumstances, but the later cases tend to condemn the liar rather than his victim. In any event, where the facts are peculiarly within the knowledge of the person making the representation and the representation is not transparently false, the other party has a right to rely on it. This right is not lost though the other party makes an investigation of his own.

Example: A owns a stationery business with an average annual profit of \$3000. By falsely representing his net profit as \$10,000, he sold his business to B, who would not have bought it but for the misrepresentation. In an action by B for rescission, A defends on the ground that B had made inquiries of other persons and could have discovered the truth had he been more diligent. Such defense must fail. The facts were peculiarly within

¹⁵ *James v. Piggott*, 70 W.Va. 435, 439.

¹⁶ *Ray County Savings Bank v. Hutton*, 224 Mo. 42.

A's knowledge, and B had a right to rely on A's representation. A could not complain that B failed to discover A was a liar.

(f) *Damage or injury.* In all cases of actionable fraud, one must show loss or injury if he is to recover damages for the fraud.¹⁷

Example: A sells B 100 shares of XYZ common at \$50 a share on the false representation that he had secret information from the president of the XYZ Company of a forthcoming extra dividend. After buying the stock, B resells it at a profit, then discovers A's fraud. An action by B against A based on the fraud would fail of damage.

127. Statement of opinion v. statement of fact. Mere expressions of opinion, however false, cannot constitute actionable fraud. In this category may be classed "dealers' talk," "puffing," "boosting," and the like, commonly indulged in by salesmen anxious to make a sale.

A *misrepresentation of the law* is construed as a statement of opinion, rather than fact, unless the misrepresentation is deliberately made by one who is supposed to know the law to one ignorant of it.¹⁸

128. Expression of expectation v. misrepresentation of present intention. An expression of expectation, such as that "gross sales are certain to reach \$1,000,000 by 1950," or that "this motor will outperform any other on the market," are mere statements of opinion, and as such furnish no basis for actionable fraud.¹⁹ On the other hand, by the weight of authority in this country,²⁰ promises made as a means of deception, with no intention of keeping them, constitute a false representation of one's state of mind and may therefore be classed as fraud.

Example: Plaintiff owned 60%, defendant 10%, of the stock of a baking company. Defendant told plaintiff he intended to start a baking company of his own 500 miles away. Thereupon plaintiff bought defendant's stock. Immediately thereafter defendant started a competing company in the same city. Defendant's alleged intention was obviously contrary to his true intention: The sequence of events would not be con-

¹⁷ *Norris v. Norris*, 50 Cal. App. 2d 726, 123 P. 2d 847; *Butts v. Groover*, 66 Ga. App. 20, 16 S.E. 2d 894; *Kloppenburg v. Mays*, 60 Idaho 19, 88 P. 2d 513; *Barron G. Collier, Inc., v. Connelley*, 134 Tex. 569, 137 S.W. 2d 14—*Biggs v. Loyd*, (Tex. Civ. App.), 177 S.W. 2d 1020.

¹⁸ *Ramos v. Pacheco*, 64 Cal. App. 2d 304, 148 P. 2d 704, 708; *Lone Star Olds Cadillac Co. v. Vinson*, Civ. App. (Tex.), 168 S.W. 2d 673.

¹⁹ *Williams v. Williams*, 238 Ala. 637, 193 So. 167; *Men About Town v. Budde*, 292 Ky. 394, 166 S.W. 2d 305; *McArthur v. Fillingame*, 184 Miss. 869, 186 So. 828; *Kelley v. Illinois Cent. R. Co.*, 352 Mo. 301, cert. den., 177 S.W. 2d 435, 64 S.Ct. 1055, 322 U.S. 738, 88 L.Ed. 1572; *Bauer v. Monroe* (Mont.), 158 P. 2d 485.

²⁰ 17 *Corpus Juris Secundum* 510.

sistent with a mere change of mind. An action for rescission based on fraud would probably succeed.

129. Remedies of defrauded party. A defrauded party may elect to affirm or disaffirm a fraudulent contract, but he cannot do both: If he does the one, he waives the other; that is, he cannot treat a contract as both valid and void. However, his affirmance merely bars a subsequent rescission; it does not bar a suit for damages based on the fraud. Neither does it bar the defrauded party from "sitting tight," refusing to perform, and—in case he is sued—urging the fraud as a defense. If the defrauded party prefers to rescind, he may do so by giving notice to this effect, or, if he desires complete relief, he may pray for rescission in a court of equity. The Court sums up the remedies of a defrauded party as follows:

"(1) He may rescind the contract by promptly tendering back all that he has received under it. He may then bring an action at law upon the rescission to recover back what he has paid or (2) defend an action brought against him on the contract, setting forth the fraud and rescission as a defense. (3) He may bring an action in equity for rescission, the tender may be made in the complaint and must be kept good at the trial, and the court will adjust the relief as equity requires upon the facts established. (4) He may affirm the contract and sue for his damages. (5) If sued upon the contract, he may counterclaim his damages." ²¹

130. Warranties *v.* representations. Warranties are assurances which are part of a contract. Hence the important thing about a warranty is: whether it is performed. A representation is a statement which induces a contract. Hence the important thing about a representation is: whether it is true or false. "A warranty differs from a representation in that a warranty must always be given contemporaneously with, and as part of, the contract; whereas a representation precedes and induces to the contract. And, while that is their difference in nature, their difference in consequence or effect is this: that, upon breach of warranty (or false warranty), the contract remains binding, and damages only are recoverable for the breach; whereas, upon a false representation, the defrauded party may elect to avoid the contract, and recover the entire price paid." ²²

²¹ *Wood v. Dudley*, 188 App. Div. 136.

²² *Black's L. Dic.*, 3d Ed., 1833. This distinction, expressing the common law rule, has been modified by statute; for example, in respect to sales (sec. 436) and insurance (sec. 1012).

131. Mistake. A mistake is a misunderstanding of fact. Mistakes may be *mutual* and *unilateral*.

132. Mutual mistake. A mistake is mutual when made by both parties. In such case, there is no real meeting of minds, hence no real contract; and either party may avoid or rescind. Mutual mistakes may relate to:

Terms of contract, such as price, cash or credit, delivery or no delivery, and so on;

Existence of subject matter, as where A, owner of a mill in Maine, meets B in New York and sells him the mill, both A and B being unaware that the mill was destroyed by fire the night before; or where a contract, based on a survey, is made for the sale of a timber tract which, unknown to both parties, has been stripped between the time of survey and sale;

Identity of parties, as where two parties enter into a contract, each believing the other to be someone else;

Identity of subject matter, as where the owner of two houses on Prospect Street agrees to sell "my house on Prospect Street," neither party meaning the same house as the other;²³

Nature of the subject matter, as where I sell you a bar of silver which both of us believe to be sterling, but which actually is not;

Quantity of subject matter, as where I sell you, out of a stock pile, a box supposed by both of us to contain a dozen silver knives and forks, which actually contains but half a dozen.

The foregoing instances relate to *fact*. Mutual mistake involving *opinion* is usually no ground for avoiding or rescinding a contract; such as mutual mistake about quality, or value, or as to the law.

Examples:

(1) Both buyer and seller of a stone thought it was of small value, whereas in reality it was precious. The court held the contract binding.²⁴

(2) A contract is made to sell lands. Both parties know that a neighbor has been crossing the lands for seventeen years, but both assume that no legal right of way can be established in less than twenty years. Both are mistaken: the law of that state has reduced the period to fifteen years. The mistake being one of law, not of fact, the seller would be liable on his contract.

133. Unilateral mistake. When a mistake is made by one party to a contract, but not by the other, it is unilateral. Such mistakes do not as a rule furnish the basis for avoidance or rescission, with the following exceptions:

(a) *Taking unconscionable advantage of inadvertent error*, especially where one has not changed his position by acting on the error.

²³ *Kyle v. Kavanaugh*, 103 Mass. 356.

²⁴ *Wood v. Boynton*, 64 Wis. 265.

Example: If a building contractor orders a list of lumber, and the lumberman erroneously computes the bill to his disadvantage, the lumberman is not bound by his mistake, though it be unilateral, so long as the contractor has not yet changed his position by acting on the bill, as by submitting a bid based upon it.²⁵

(b) *Unilateral mistake known to the other party.* If one party makes a mistake and the other party knows it, he cannot take advantage of such mistake unless the mistake is one of opinion, not fact. For example, in the lumber case above, if the contractor knew that the lumberman had miscalculated, he could not take advantage of it even if he had acted upon it before the lumberman discovered it. But if the lumberman believed he was getting a good price, and the contractor knew the contrary, that would have no effect on the contract.

(c) *Mistake equivalent to fraud.* Where a unilateral mistake is obvious to the other party and good faith would require him to correct the error, failure to correct it amounts to fraud.²⁶

Example: A diamond merchant's clerk sells a gem to Williams for \$650. The price tag reads \$6500. If Williams is fully aware of the clerk's error, his failure to correct it amounts to fraud: suit for rescission is in order.

However, a superior knowledge of values imposes no duty to speak. As noted in section 126 (subd. (a)), "Silence", a failure to speak where there is no duty to speak does not constitute fraudulent concealment.

Example: After selling *Y* an oil painting worth \$1200 for \$75, *X* sues to recover the painting or, in the alternative, the sum of \$1125 as the balance of its true value. Although *Y* knew that the painting was valuable, he owed *X* no duty to speak. (If, however, *Y* had spoken, and had thereby misled *X* as to the true value of the painting, the transaction would have been vulnerable.)

134. Duress. Duress is coercion causing action or inaction contrary to the victim's will.²⁷ It may take various forms: physical force, imprisonment, bodily harm, or the threat of any of these. Under the common law, a threat of imprisonment was not duress unless such imprisonment were illegal or wrongful. This is no longer the rule. Likewise, threats of criminal prosecution constitute duress regardless of guilt or innocence, so long as they induce a contract against a party's will. However, the threat of civil suit (sec. 71) does not constitute duress.

Threats involving relatives. Threats involving a victim's near relatives by blood or marriage, such as wife, husband, parent, child or other near

²⁵ *Ex parte Perusini Const. Co.*, 242 Ala. 632, 7 So. 2d 576; *Garsick v. Dehner*, 145 Neb. 73, 15 N.W. 2d 235, 237; *Steiner v. Fecycz*, 72 Ohio App. 18, 50 N.E. 2d 617.

²⁶ *Harding v. Robinson*, 175 Cal. 534, 166 P. 808.

²⁷ 17 *Corpus Juris Secundum* 525.

relative constitute duress, whether the threatened prosecution or imprisonment is lawful or not and regardless of the guilt or innocence of the relative.²⁸ So is a threat to publish defamatory matter concerning a near relative (sec. 1391), since its execution might entail mental pain, distress and injury to victim and relative alike. In all cases such threats, to constitute duress, must have directly influenced the victim in making or not making a contract.

Effect of duress. Since mutual assent, from its very nature, must be voluntary, any influence which makes assent involuntary renders the contract voidable at the option of the victim.

135. Undue influence. Undue influence is the exertion of influence upon a person by means not amounting to duress, yet negating the idea of voluntary assent. Courts of equity view with disfavor contracts induced by undue influence. Such influence may result from:

Relationship of parties, as in the case of *guardian and ward, trustee and beneficiary, principal and agent, attorney and client, physician and patient*;²⁹ or

Weakness of mind, resulting from inferior capacity or physical condition.³⁰

136. Parties: number and competency. There must be at least two parties to every contract, both of whom must be in existence when the contract is made. All parties are presumed to have capacity to contract, so long as they have a whole and mature mind capable of intelligent assent. Where these qualities are absent, the law makes exceptions. *Examples*: infants; married women; insane persons; drunkards; convicts; aliens; corporations.

137. Infants. The general status of an infant has already been defined (sec. 24). Infants have the *right* to make contracts and to hold adults to them, but they are not *liable* on their contracts, with the following qualifications:

²⁸ *Hutchinson v. Hutchinson*, 48 Cal. App. 2d 12, 119 P. 2d 214—*Ramos v. Pacheco*, 64 Cal. App. 2d 304, 148 P. 2d 704; *Coleman v. Crescent Insulated Wire & Cable Co.*, 350 Mo. 781, 168 S.W. 2d 1060; *Motor Equipment Co. v. McLaughlin*, 156 Kan. 258, 133 P. 2d 149, 155; *Morrill v. Amoskeag Sav. Bank*, 90 N.H. 358, 9 A. 2d 519.

²⁹ *Merritt v. Easterly*, 226 Iowa 514, 284 N.W. 397; *Appeal of Robie*, 141 Me. 369, 44 A. 2d 889; *Gaver v. Gaver*, 176 Md. 171, 4 A. 2d 132; *Beattie v. Bower*, 290 Mich. 517, 287 N.W. 900; *Hedrick v. Hedrick*, 350 Mo. 716, 168 S.W. 2d 69; *Stieber v. Vanderlip*, 136 Neb. 862, 287 N.W. 773; *Peyton v. William C. Peyton Corporation*, 23 Del. Ch. 321, 7 A. 2d 737, 123 A.L.R. 1482; *Quist v. Dorn*, 301 Ill. App. 264, 22 N.E. 2d 729.

³⁰ *Cook v. Hollyday*, (Md.), 45 A. 2d 761

Necessaries. Infants are liable for necessities, but only to the extent of their reasonable value.³¹ Hence even for necessities, an infant is not, strictly speaking, liable on *his* contract, but on the one that the law makes for him. Necessaries embrace food, clothing, shelter, medical attendance, ordinary education and similar fundamentals of living unless they duplicate those already furnished.³² Beyond these basic requirements, what constitutes a necessary depends on the infant's station in life. A purchase classed as a necessary to the millionaire's son may be a luxury to the son of a day laborer. A classical or professional education may be a necessary to one infant and a luxury to another.

Example: An infant contracted for a correspondence course in steam engineering. After receiving some instruction and making some payments, he dropped the course. In a suit on the contract, it was urged that education is a necessary. Said the court: "A proper education is a necessary, but what is a proper education depends on circumstances. A common school education is doubtless necessary in this country. . . . A classical or professional education, however, has been held not to come within the term. . . . Still, circumstances . . . may exist where even such an education might properly be found a necessary. . . . In the absence of all facts relating to any of these subjects we think that a course of instruction in 'Complete Steam Engineering' . . . was not a necessary. . . ." ³³

Luxuries: disaffirmance. An infant's contracts for anything other than necessities are valid but voidable at his option, and the infant may exercise this option by disaffirming the contract at any time during infancy or promptly after reaching majority. Where a contract is executed and the infant has performed, he cannot rescind or disaffirm without returning or accounting for the value received by him.³⁴

Disaffirmance is not retroactive. If an infant seeks the value of something he is entitled to, but which has depreciated in value, he must take such value as of the date of disaffirmance.

**Example:* In *Joseph v. Schatzkin*,³⁵ plaintiff, an infant, opened a margin account with stockbroker X, to whom he later transferred a similar account he had with stockbroker Y. The transfer involved 400 shares of the then market value of \$17,450, on which the infant owed \$13,907.91. X paid Y this debit balance, leaving the infant's equity in these 400 shares at \$3542.09. Two months later, the stock having declined sharply in value, plaintiff closed his account and received \$70.99 in full payment of his credit

³¹ *Sumner v. Hall*, 273 Ky. 138, 116 S.W. 2d 309; *In re Dzwendiewicz's Estate*, 231 Mich. 165, 203 N.W. 671; *O'Donniley v. Kinley*, 220 Mo. App. 284, 286 S.W. 140; *Quinley v. Desautels*, 45 R.I. 106, 120 A. 65.

³² *Utterstrom v. Myron D. Kidder, Inc.*, 124 Me. 10, 124 A. 725; *Chabot v. Paulhus*, 32 R.I. 471, 79 A. 1103; *Worman Motor Co. v. Hill*, 54 Ariz. 227, 94 P. 2d 865, 124 A.L.R. 1363; *Thrall v. Wright*, 38 Vt. 494.

³³ *International Text Book Co. v. Connelly*, 206 N.Y. 188, 195-196. (See section 1393.)

³⁴ *Weeks v. Berschauer*, 140 Kan. 244, 36 P. 2d 81, 83; *Merchants' Credit Bureau v. Kaoru Akiyama*, 64 Utah 364, 230 P. 1017.

³⁵ 259 N.Y. 241, 181 N.E. 464.

balance. Six weeks later plaintiff rescinded his agreement with X and sued to recover his original equity of \$3542.09 in the 400 shares. The market value of the 400 shares at the time of such disaffirmance was \$14,227. The court held that plaintiff's disaffirmance could not render the transaction void as of any time prior to the date of disaffirmance. On this basis, plaintiff was entitled to recover:

Value of 400 shares on disaffirmance	\$14,227.00
Less X's lien for paying plaintiff's debt to Y	13,907.91
	<hr/>
	\$ 319.09
Less, already paid plaintiff	70.99
	<hr/>
Net to plaintiff	\$ 248.10

Ratification. Upon attaining majority, an infant may ratify any contract which he has the right to disaffirm. Once an infant ratifies, he cannot disaffirm.³⁶ Ratification may be *express* (that is, in words, oral or written); or *implied* (as by an act done after reaching majority indicating approval or by failing to disaffirm promptly upon reaching majority).

Example: Six weeks before his twenty-first birthday, an infant buys an automobile for \$2000 on a down payment of \$100, balance on credit. Upon attaining majority, the infant may ratify the contract orally, by letter, by affirmative act (reselling the car or continuing to make payments), or by using the car and failing to disaffirm.

Business contracts. Some states have adopted statutes making infants who engage in business liable on their business contracts. In New York, for example, a contract by an infant eighteen years of age or over is binding on him if (a) it is made in connection with a business in which he is engaged and (b) it is reasonable and provident. Other states, including Iowa, Kansas and Georgia, have similar statutes. These statutes reflect a rising standard of necessities to self-supporting infants. (If, for example, the correspondence school case cited under "Necessaries" in this section were to be tried today, a majority of states would probably class such education as a necessary to a self-supporting infant or one in moderate circumstances.)

Contracts of marriage. A minor's contract to marry is voidable at the minor's option. But if the marriage is consummated, and the minors are of legal age (which in many states is fixed at eighteen for both males and females), it is not subject to annulment on the ground of infancy.

Infant misrepresenting age. Infants, as previously noted (sec. 24), are liable for their torts. There is no good reason why an infant who misrepresents his age should not be liable for deceit. Yet not all states are agreed on this. In many states, the courts refuse to allow a tort to be used as a lever for enforcing an infant's contract. For example, in the correspondence school case cited under "Necessaries" in this section, the court said

³⁶ *Lee v. Thompson*, 124 Fla. 494, 168 So. 848; *First Nat. Bank v. Guenther*, 125 Neb. 807, 252 N.W. 395; *Smith v. Williams*, 141 S.C. 265, 139 S.E. 625, 54 A.L.R. 964.

that an infant "is not estopped from pleading his infancy by any representation as to his age. . . . To hold otherwise would in many cases deprive infants of the protection extended to them at an age when the mind and judgment are conclusively presumed to be immature and they need to be shielded from their own imprudence and folly."

In many other states, however, an infant is liable in a separate action for deceit. This is especially true in states which have statutes providing that a minor cannot disaffirm his contract if he misrepresents his age to an adult who relies on the misrepresentation. Among such states are Iowa, Kansas, Utah and Washington.

Infancy no defense to adult. It is the infant, not the adult, who may plead infancy as a defense. Where the infant, however, is guilty of fraud in inducing the contract (as in misrepresenting his age), the defrauded adult may avoid the contract.³⁷

138. Married women. Though in Florida married women must obtain court orders to become "free dealers," and in Pennsylvania they are not liable on surety contracts or accommodation paper, generally speaking the common law disabilities of married women in the United States have been removed (sec. 23).

139. Insane persons. As to contractual capacity, persons are insane if derangement of mind prevents the giving of intelligent assent. Persons may be *adjudged* or declared insane after inquiry, and a guardian or *committee* appointed to look after their affairs. Prior to such adjudication, contracts with insane persons are *voidable*; thereafter, *void* (sec. 176).

140. Drunkards. Intoxication is ordinarily no defense to a contract, unless fraudulently procured, or unless it is so extreme as to negative the capacity for intelligent assent.³⁸

141. Convicts. Life convicts may make binding contracts, but lacking civil rights, they may not enforce them.

142. Aliens. Contracts with aliens are fully enforceable. Contracts with enemy aliens are suspended upon declaration of war; if made after war is declared, they are void. As to existing contract rights, every resident, whether citizen or alien, may freely resort to our courts, but the right of an alien to do so may be curtailed, regulated, or entirely withheld by

³⁷ *Western Union Telegraph Co. v. Ausbrooks*, 148 Tenn. 615, 257 S.W. 858, 33 A.L.R. 330; *Welch v. King*, 279 Mass. 445, 181 N.E. 846; *Hammassapoulo v. Hammassapoulo*, 134 S.C. 54, 131 S.E. 319; *Cheney v. Cheney*, Civ. App., 82 S.W. 2d 1024, reversed on other grounds *Cheney v. Coffey*, 131 Tex. 212, 113 S.W. 2d 162, rehearing denied 131 Tex. 212, 114 S.W. 2d 533; *Horney v. Downs*, 209 Ky. 255, 272 S.W. 728.

³⁸ *Seminara v. Grisman*, 137 N.J. Eq. 307, 44 A. 2d 492.

statute (such as the Trading With The Enemy Act). By Act of Congress all property rights of an enemy alien, including contract rights, may be taken over by the Alien Property Custodian.

143. Corporations. A corporation is an artificial person under the law and as such may make contracts the same as natural persons. However, corporations from their very nature labor under certain disabilities and limitations more fully discussed hereafter (secs. 877-884).

144. Consideration: nature and necessity for. Consideration is something of value given for a promise. Without it, a promise is *nudum pactum*—a naked pact, without force in law. A promise supported by consideration is binding; that is, a contract.

Example: A, by written contract, buys B's drygoods store, pays \$2000 down, and agrees to pay the balance of \$2500 on or before February 1, 1948. On February 1, 1948, A secures B's agreement to postpone payment until April 1, 1948, but immediately thereafter B, ignoring his promise, sues A for the balance. The suit will succeed: B's promise was "naked"—not supported by consideration.

145. Act v. promise as consideration. The thing of value called for by a promise may be either an act or a promise to do the act.

If an act is called for as consideration for a promise, only the act, not a promise to perform it, will constitute consideration to bind the promise.

Example: A promise to pay \$50 "if you can deliver the coal to my bin by Friday" becomes obligatory, not upon a *promise to deliver* the coal, but by the *act* of delivery itself. This is known as a *unilateral contract* (sec. 174).

On the other hand, if a promise or commitment to do the act is called for, the making of such promise or commitment constitutes the consideration to support the other promise; that is, each promise immediately becomes obligatory because of the other. This is known as a *bilateral contract* (sec. 174).

146. What may constitute consideration. Anything of value given for a promise may constitute consideration. "Value" may take the form of a benefit to the promisor or a sacrifice to the promisee.

Benefits as consideration may include money, property or services, or the promise thereof.

Detriment or sacrifice as consideration may consist in the promisee's giving up some right, or promising to give it up, whether such sacrifice benefits the other party or not.

Example: If an uncle promises his nephew \$5000 for refraining from liquor, tobacco, swearing and gambling until the nephew becomes of age, the uncle must pay if the nephew makes these sacrifices.³⁹

147. Mutuality of obligation. If one party to a contract is bound and the other is not, the contract is unenforceable for lack of mutuality of obligation: Both parties must be bound, or neither is.⁴⁰

Example: Cooper's Glue Factory writes Schlegel Manufacturing Co., "We are instructed to enter your contract for your requirements in 1927, deliveries to be made as per your orders during the year." The Schlegel Company signs its name to the letter. After some deliveries, the Cooper Company stops further shipments, and the Schlegel Company sues. *Held*, no contract. The agreement lacked mutuality. The Schlegel Company in signing the letter did not obligate itself to do anything.⁴¹

A promise to buy stock at a given price and under given conditions, in exchange for a promise to hold it for sale to the other party, is not lacking in mutuality.

Example: Hirschberg, selling agent for Deal Knitting Mills, Inc., owned 100 shares of its stock. By contract under seal Hecht, president of the corporation, agreed to repurchase Hirschberg's 100 shares at par at any time within 30 days upon Hirschberg's written request. Hirschberg gave Hecht the right to repurchase the shares at par at any time within 30 days after Hirschberg's death or termination of services as the company's selling agent. On November 3, 1930 Hirschberg made written demand that Hecht purchase the stock, but Hecht refused, claiming that the written agreement lacked mutuality and consideration. The lower court sustained him, but on appeal, the decision was reversed. The appellate court pointed out that Hirschberg had obligated himself to hold the stock for the agreed period. The stock might go up in value; another purchaser might offer more for it; but Hirschberg was bound. Hence Hecht was bound.⁴²

148. Options and mutuality. An option is a promise to hold an offer open. Like any other promise, it is ineffective without consideration. In a limited sense, options dispense with mutuality since one of the parties may be bound or not, as he sees fit, while the other is absolutely bound. This is especially

³⁹ *Hamer v. Sidway*, 124 N.Y. 538.

⁴⁰ *Friedman v. Decatur Corporation*, 77 U.S. App. D.C. 326, 135 F. 2d 812; *Heisley v. Allied American Mut. Fire Ins. Co.*, 71 Ga. App. 107, 30 S.E. 2d 285; *Duclos v. Turner*, 204 Ark. 1000, 166 S.W. 2d 251; *Stephen L. Guice & Co. v. Perkowski*, (La.) App., 12 So. 2d 692.

⁴¹ *Schlegel Manufacturing Co. v. Cooper's Glue Factory*, 231 N.Y. 459.

⁴² *Hirschberg v. Hecht*, 235 App. Div. 580, affirmed 261 N.Y. 542, 185 N.E. 730.

true where the statute (as in New York) provides that a *written option* is binding without consideration. In reality, however, an option (where there is consideration) is mutually obligatory: One party is obligated to furnish a consideration and the other to hold an offer open.

In a few states,⁴³ reflecting the common law rule, an option under seal is binding because a seal, at common law, imports consideration.

Example: On May 1 *A* sends *B* a formal written offer under seal to sell *B* certain merchandise at a specified price, at any time up to May 15. On May 5 *A* writes *B* withdrawing the offer. Upon receiving the letter of withdrawal, *B* formally accepts the offer, then sues *A* for breach of contract. In states recognizing the common law rule that a seal imports consideration, and also in states which require no consideration where an option is in writing, *B* would succeed. In other states *B* would fail, since *A*'s option was not supported by consideration.

149. Good *v.* valuable consideration. With respect to the enforceability of contracts, it is sometimes necessary to distinguish between *good* and *valuable* consideration.

Good consideration is consideration based on sentiment, or a moral (as distinguished from a legal) obligation. For example, a promise to pay a debt outlawed by the statute of limitations is a promise based on a moral, rather than on a legal obligation, hence based on good, not valuable consideration.

Valuable consideration is something representing a material benefit to the promisor or some sacrifice or detriment by the promisee. The word "consideration," standing alone, generally means valuable consideration.

With certain exceptions (sec. 152), good consideration will support an executed but not an executory (unperformed) contract. Only valuable consideration will support an executory contract.

Example: Hawkins, upon reaching the age of 65, retires from Culver's employ. Immediately thereafter Culver promises Hawkins \$100 a month for life. Culver makes the payments for four years, then stops. Since Culver's promise was based on good consideration only, the contract, so far as it is still executory, cannot be enforced. Neither may Culver rescind the contract so far as it is executed: The payments already made, stand.

⁴³ *Shelden v. Bright*, 135 Kan. 361, 10 P. 2d 831; *Storch v. Duhnke*, 76 Minn. 521, 79 N.W. 533; *Hartford-Connecticut Trust Co. v. Divine*, 97 Conn. 193, 116 A. 239, 240.

150. Executory and executed (past) consideration. Consideration to be furnished in the future, as the thing of value supporting a promise, is executory. If the consideration, unsolicited, is given first and *then* the promise is given for it, such promise is based on *executed*, or *past* consideration.

Example: Following a storm, you repair the roof of my house in my absence and without my knowledge or consent. On my return I promise to reimburse you and to compensate you for your time and trouble. Such a promise is based on past consideration.

Executed or past consideration will not support a promise; that is, a promise based on past consideration is not binding.

The foregoing rule may be changed by statute. In New York, for example, the statute provides that a *written* promise based on past consideration is binding.

151. Adequate consideration. The court is not concerned with the question of whether or not the thing supplied as consideration was adequate. The adequacy of consideration is left to the parties. Hence, a large contract can be bound by a small consideration.⁴⁴ Only where the consideration is so ridiculously inadequate as to suggest fraud, will the courts interfere to set aside a contract for lack of consideration.⁴⁵

152. Moral obligation v. legal obligation. A moral obligation will not constitute consideration, unless it is also a legal one. For example, if you voluntarily pay my debt to Smith, my moral obligation to repay you would not constitute consideration.⁴⁶ If, however, I did repay you, the transaction would stand: Good consideration supports an executed contract (sec. 149). Where a moral obligation was formerly a legal obligation, a *written* promise may in certain cases convert it into a legal obligation again.

⁴⁴ *Alabama Mills v. Smith*, 237 Ala. 296, 186 So. 699—*Gray v. Gray*, 246 Ala. 627, 22 So. 2d 21; *Hanks v. McNeil Coal Corp.*, 114 Colo. 578, 168 P. 2d 256; *Affiliated Enterprises v. Waller, Super.*, (Del.) 1 Terry 28, 5 A. 2d 257; *Franklin Fire Ins. Co. v. Noll*, 115 Ind. App. 289, 58 N.E. 2d 947; *Featherstone v. Walker*, 43 N.M. 181, 88 P. 2d 271; *Williston Sav. & Loan Ass'n v. Kellar*, (N.D.) 22 N.W. 2d 30; *Matthews v. Matthews*, 24 Tenn. App. 580, 148 S.W. 2d 3.

⁴⁵ *Woods v. Griffin*, 204 Ark. 514, 163 S.W. 2d 322; *Sova v. First Nat. Bank of Ferndale*, 18 Wash. 2d 88, 138 P. 2d 181, 190.

⁴⁶ *Lanfier v. Lanfier*, 227 Iowa 258, 288 N.W. 104; *Succession of Burns*, 199 La. 1081, 7 So. 2d 359; *Fender v. McCain*, 144 Neb. 58, 12 N.W. 2d 541; *White Mountain Nat. Bank v. Malloy*, 93 N.H. 197, 37 A. 2d 785; *In re Knisely's Estate*, 12 Ohio Supp. 140.

Example: A claim barred by the statute of limitations, or discharged in bankruptcy, leaves only a moral obligation, yet a subsequent *written* promise to pay such claim is enforceable.

153. Fulfilling a duty no consideration. Fulfilling or promising to fulfill a duty already in existence represents no sacrifice of a right, hence cannot constitute consideration.

Pre-existing contract obligation. If a person is obligated by contract to do a certain thing for a certain price, he has no further right to promise the same thing for a higher price, since the doing of that thing is no longer his to bargain away.

Example: An accountant engaged to make an audit at specified per diem rates uncovers a defalcation whereby he saves his client \$25,000. When the audit is concluded, the grateful client promises the accountant an additional \$5000 for his services. Should the client refuse to pay the additional fee, the accountant could not compel payment, because he was already obligated by contract to render the service for which he was promised extra payment.

Agreement to accept part payment in full. Payment of a lesser sum than that actually due on a liquidated debt will not constitute consideration for a promise to accept such payment in full satisfaction. To make such payment is but to discharge an existing obligation.⁴⁷

Example: Peter Winter, being financially embarrassed, gave his creditors notes in payment of their respective claims. On due date, the creditors surrendered their notes upon payment of 50% of their respective face values. Such payments would furnish no consideration for a discharge of the full amounts due, unless each creditor (1) made a gift of the balance, or (2) gave a binding release (sec. 226), or (3) accepted the payment as part of a composition (sec. 154). However, as noted in the paragraph immediately following, if the payments were made before maturity, the debts would be fully discharged.

An agreement to accept part payment in advance of due date, as payment in full, is binding, because prepayment may constitute consideration for accepting less than the amount due.⁴⁸

An agreement to accept part payment plus something additional, as payment in full, is binding.⁴⁹

Example: Geller owes Gordon \$650, which is past due. He offers Gordon \$150 plus an automobile worth approximately \$400 in full satisfaction of the debt. If Gordon accepts, the debt is discharged: The parties may fix what value they please on the automobile as adequate consideration.

Promise to extend payment. If a creditor promises to extend payment of a debt, the promise is not binding on the creditor unless he gets something for it in addition to that which he is already entitled to receive.

⁴⁷ *Mutual Home & Savings Ass'n v. Welker*, (Ohio) 42 N.E. 2d 167, 170.

⁴⁸ *Jones v. Vennerberg*, 133 Neb. 143, 274 N.W. 494, 496; *Levine v. Blumenthal*, 117 N.J. Law 23, 186 A. 457, affirmed 117 N.J. Law 426, 189 A. 54.

⁴⁹ *Tucker v. Dolan*, 109 Mo. App. 442, 84 S.W. 1126.

Examples:

(1) A promise to extend payment of a debt for one month if the debtor will agree "to surely pay it then," is not binding, because the creditor is entitled to payment anyway.

(2) A promise to extend the time of payment for three months of a note that bears no interest, if the maker will pay interest at 5% from and after due date, is not binding, because the holder is entitled *by law* to interest *after due date*. (Such legal interest exceeds the rate of 5% in most states.)

Forbearance to sue. Forbearance or sacrifice of the right to sue constitutes valuable consideration. However, your promise to pay me \$100 in consideration of my forbearance to sue you, would be unenforceable unless there was an honest dispute between us. If I have no colorable right to sue, I forbear nothing by withholding suit.

Withdrawing from suit in consideration of secret preference. If one of the creditors of an insolvent estate withdraws from a pending suit brought on behalf of all the creditors, in consideration of the debtor's promise to pay his claim in full, the debtor's promise, being based on the illegal consideration of an unlawful preference (sec. 1293), is unenforceable (sec. 1400).

154. Composition with creditors. An agreement among creditors and with a debtor to compromise for less than the amounts due them is more than a mere promise to accept a smaller sum for a larger sum due, because it involves mutual forbearances among the creditors, as well as their promises to the debtor. These forbearances furnish consideration because they represent not only mutual sacrifices, but also a mutual exchange of benefits among the creditors in not pressing their respective claims against the debtor, and thereby eliminate the mad scramble among creditors which inevitably results in less being available for all.

155. Charitable subscriptions. Charitable subscriptions standing by themselves are in effect promises to make gifts. The rule that mutual promises to subscribe supply mutual consideration is not uniform. The English view is that such promises are gratuitous, hence not binding. The view most commonly held in this country is that a subscription is an offer to contract which becomes binding as soon as the work towards which the subscription was promised has been done or begun, or as soon as liability is incurred in reliance on the subscription.

156. Consideration in contracts under seal. Under the common law, contracts under seal were binding regardless of consideration. In this country, only a small minority of states

observe the common law rule.⁵⁰ In a majority of states, the distinction between sealed and unsealed contracts has been abolished by statute.⁵¹ In several states where contracts under seal import consideration the law allows proof to the contrary, upon the establishment of which the contract is unenforceable.⁵²

157. Valid subject matter. The law will not enforce an agreement to do what the law says must not be done. Hence contracts to do any of the numerous prohibited acts referred to in sections 31 to 48 would be void for invalid subject matter.

158. Wagering contracts. A wagering contract is one based on pure chance, wherein what one party gains the other must necessarily lose. Examples: games of cards, dice, lotteries and betting on the outcome of an event. Formerly, under the common law, and now in the so-called "common law states," wagering contracts were and are permitted. Other states have passed laws against them. In New York, money lost on a bet or wager may be recovered by the loser, whether in the hands of a stakeholder, or the winner, but the winner cannot recover from the loser. If more than \$25 is lost on a game by a player or spectator, the loser may get it back if he acts within three months; otherwise, the Overseer of the Poor may sue for the winnings, plus three times as much by way of penalty.

Winner's rights against third party. Where the loser pays over a gambling debt to a third party (for example, to the winner's attorney), the latter cannot refuse to turn over the money to the winner on the plea that the original transaction was illegal. "In such cases the action is not based on the illegal contract, but on the independent contract of such third person to deliver over the property received by him. . . ." ⁵³

Speculations on rise and fall of market. Transactions on a stock or produce exchange, or transactions involving the purchase and sale of securities generally on the basis of pure chance, that is, on the rise or fall of the market, are wagering contracts and are unenforceable. However, the law permits the buying and selling of "futures," and of stock "on margin," on the theory that unless an intent *not to make future delivery* is shown, it will be presumed.

⁵⁰ Florida, Maine, Pennsylvania, South Carolina, Vermont, Virginia and one or two others.

⁵¹ Alaska, Arizona, Arkansas, California, Colorado, Idaho, Indiana, Iowa, Kansas, Kentucky, Minnesota, Mississippi, Missouri, Montana, Nebraska, Nevada, New Mexico, New York, North Dakota, Ohio, Oklahoma, South Dakota, Tennessee, Texas, Utah, Washington, West Virginia, Wyoming.

⁵² Alabama, Illinois, Michigan, New Jersey, Oregon and Wisconsin.

⁵³ 17 *Corpus Juris Secundum* 672.

"Puts" and "calls" (options to buy or sell stock at a given figure within a given time) are not necessarily gambling contracts.

Example: In *Story v. Salomon*,⁵⁴ defendant agreed to buy from or sell to bearer, at any time within thirty days, 100 shares of Western Union stock at 77½. The court held that in the absence of proof that the parties were merely speculating upon the fluctuations in price of the stock without intent of delivery or acceptance, the transaction could not be deemed a wager but would be presumed to be legal.

159. Contracts made on Sundays and legal holidays. Contracts, including checks and promissory notes, made on Sundays and legal holidays but not consummated or calling for performance on such days, are valid, except when the statute specifically prohibits even the making of contracts on such days. On the other hand, contracts made on any day, calling for performance on a Sunday or legal holiday, are unenforceable, excepting works of "public convenience and necessity" (sec. 43).

160. Unlicensed transactions. We have already referred to unlicensed transactions in violation of law (secs. 43-45). For services rendered as part of an unlicensed transaction, compensation may be refused with impunity.

Examples:

(1) In a state requiring real estate brokers to be licensed, Jones acts as broker in the sale of Smith's home upon an agreed commission of 5%. On Smith's refusal to pay the commission, Jones sues; but since it appears that Jones has no license, his suit will fail.

(2) A corporation, pursuant to contract, rendered architectural services in fitting up a restaurant. The restaurant refused to pay, and the corporation sued. The court denied recovery on the ground that the plaintiff was not licensed (in fact, being a corporation, could not be licensed under the state law prohibiting corporations from practicing architecture).⁵⁵

Restrictions on professions. The professions in particular are subject to legal restrictions: (1) Licenses to practice are required, to maintain professional standards of fitness. (2) Solicitation of clients, patients, and so on is prohibited, not only as incompatible with professional dignity, but also on the theory that professional fitness rather than "go-getting" ability should govern the practice. (3) Professional service sets up a *fiduciary relationship* (sec. 562) which imposes higher standards of dealing than those in the common marts of trade.

Champerty is the encouragement of litigation by contract whereby an

⁵⁴ 71 N.Y. 420.

⁵⁵ *American Store Equipment, etc. Corporation v. Jack Dempsey's Punch Bowl, Inc.*, 174 Misc. 436, 21 N.Y. Supp. 2d 117, affirmed 258 App. Div. 794, 16 N.Y. Supp. 2d 702.

attorney agrees to conduct a suit at his own risk and cost in consideration of a share of the proceeds, if successful.

161. Restraint of trade. Competition is "the life of trade." Hence agreements which restrain the free play of competition are contrary to public policy and void. Some restraint of trade is inevitable.

Reasonable restraint of trade. The purchaser of a retail store having a local trade, such as a grocery, drugstore or dairy, may protect the store's good will by exacting from the seller an agreement not to open a new store within reasonable limits necessary to protect the purchase, such as for a given period of years, within a radius of a given number of blocks, and so on.

Unreasonable restraint of trade. If in the above illustration the purchaser exacted a promise from the seller not to compete anywhere in the United States, such a restraint would be unreasonable because unnecessary to protect the buyer's good will. But a nationwide restraint would not be unreasonable if the sale involved a nationwide chain of stores.

Tests of reasonableness. The basic test of reasonableness is whether the restraint is necessary to protect the purchase. The courts in applying this test have tended to hold that where the restraint is unlimited as to time and space, or even as to space alone, the restraint is unreasonable.

Examples:

(1) An accountant, retiring from practice and selling his assets and good will, agrees not to engage in the public practice of accounting anywhere for ten years. *Agreement invalid:* restraint unreasonable, not necessary to protect purchaser.

(2) A retail furniture dealer with no trade outside the county, in selling his business agrees not to re-engage in the furniture business for five years, anywhere in the state. *Agreement invalid:* restraint unreasonable, not necessary to protect purchaser.

(3) The owner of a grocery chain in Cleveland, Ohio, in selling his entire business, agrees not to re-engage in the grocery business anywhere for ten years. *Agreement invalid:* space unlimited; not necessary to protect purchaser.

162. Business monopolies. A contract may be in reasonable restraint of trade as between the parties, yet may be invalid if it is detrimental to the public interest. A business monopoly, for example, tends to restrain trade to the public detriment. Agreements to form such monopolies are illegal, not only under the Sherman and Clayton Acts (sec. 55), but under various state antitrust statutes.

163. Government monopolies. Government monopolies, such as the post office, and government-protected monopolies, such as patents, copyrights, trade-marks and trade names (sec. 1068), being in the public interest, are lawful.

164. Price fixing. Congress or the state legislatures may fix maximum and minimum prices in the public interest, but price-fixing agreements among business concerns, with certain exceptions, are prohibited by law.

Patents and copyrights. If the owner of a patent grants a license to manufacture under the patent, he may restrict the price at which the licensee may sell the articles thus manufactured. Likewise, the owner of a copyright may restrict the price at which a licensee may sell the copyrighted matter. But no further restriction is permitted: Once the patented article or copyrighted matter itself is sold, the buyer is under no restriction as to its resale price.

Fixing resale price. With the exceptions noted, agreements to fix resale prices are void. Federal and state statutes, however, may validate such agreements.

Federal example: Tydings-Miller Act (sec. 55).

State example: Feld-Crawford Act (sec. 1404).

165. Restraint of employment: trade secrets. The law looks with disfavor on contracts which prohibit employees from seeking similar employment after terminating their contracts.

Examples:

(1) A contract restrained a manager on terminating his services from engaging in the clothing business for five years in any place where the employee had stores. In refusing to enforce the agreement, the court pointed out the difference between such restrictions and those which accompany the sale of a business. In the latter case, said the court, "the restrictions add to the value of what the vendor wishes to sell, and . . . what the vendee purchases. In such cases also the parties are presumably more nearly on a parity in ability to negotiate than is the case in the negotiation of agreements between employer and employee."⁵⁶

(2) See section 1403.

However, an agreement not to engage or accept employment in a competing business is valid, where necessary to protect the employer against disclosure of trade secrets obtained in confidence during the course of employment.

166. Stifling competition for public contracts. "Agreements not to compete with another in making bids, to withdraw a bid for a public or quasi-public contract, to share in the result or profits, or other agreements having a direct tendency to prevent bidding or competition, are against public policy."⁵⁷

Example: A and B, road-building contractors, agree that if A will refrain from bidding on one public road, B will refrain from bidding on the other. The agreement is void.

⁵⁶ *Samuel Stores, Inc. v. Abrams*, 94 Conn. 248, 108 A. 541.

⁵⁷ 17 *Corpus Juris Secundum* 582.

167. Contract to commit tort or breach contract. An agreement to commit a tort, such as assault and battery, libel, slander, and so on, is unenforceable. Hence an agreement which involves the breach of another contract is void (see sec. 30).

Example: *A*, a news reporter, has exclusive news rights in connection with a polar flight. *B*, another newsman, obtains passage on the plane on condition that he will send no radio reports of the flight. *B* and a certain newspaper, with full knowledge of *A*'s rights, agree that *B* is to send news reports by radio, for which the newspaper is to pay \$5,000. If *B* performs and the newspaper refuses to pay, the court will refuse to enforce *B*'s claim against the newspaper.

168. Matrimonial agreements. A contract not to marry, or having a tendency to restrain marriage, is contrary to public policy and unenforceable. So, also, is a contract to promote or encourage a divorce. However, a contract of separation is valid if made in prospect of immediate separation or after the separation takes place. An agreement on alimony, support and property rights is valid if made as part of a separation agreement or as part of impending divorce proceedings. Marriage brokerage contracts are void: They stimulate, not marriages in general, but mercenary marriages.

169. Effect of invalid subject matter. Courts generally refuse to recognize contracts tainted with illegal subject matter, and will leave the parties where it finds them. Exceptions:

Executory contracts. The law encourages parties to withdraw from illegal contracts not yet carried out. For example, if I give you money to invest in an illegal enterprise and the money is not yet so invested, I may repudiate the transaction and recover the money.

Wagering contracts. The loser may under certain conditions repudiate his contract and recover his loss. (See sec. 158.)

Contracts only partly affected by invalid subject matter. If a contract is *severable* (made up of separate obligatory parts or installments), the invalidity of one part will not necessarily invalidate the rest. But if the contract is *entire*, the illegality of any part taints the whole. For an illustration of this distinction, see sec. 177, Example (2).

170. Time. Time is a requisite of every contract in the sense that every contract involves the element of time. More accurately, time is a condition, express or implied, governing the performance of every contract. (See sec. 215.)

B. Classification and Form of Contracts

171. Classification of contracts in general. Contracts may be variously classified as follows:

(a) As to manner of showing intent: *express* and *implied*.

(b) As to whether the thing agreed to be done has or has not been done: *executed* and *executory*.

(c) As to whether the contract consists of an exchange of promises or a promise on one side only: *bilateral* and *unilateral*.

(d) As to collective liability where there are several promisors: *joint* and *joint and several*.

(e) As to enforceability: *valid*, *void*, *voidable* and *enforceable*.

(f) As to whether all parts of the contract are interdependent, or susceptible of division and apportionment: *entire* and *divisible*.

(g) As to form or formality: *contracts of record*, *specialties*, and *parol (simple)* contracts.

172. Express and implied contracts. An *express* contract is one wherein the intent of the parties is shown by words, oral or written.

An *implied* contract is one wherein the intent of the parties is shown by conduct, as where (without mentioning compensation) *A* renders and *B* accepts valuable services.

Quasi contracts are obligations in the nature of contract implied or imposed by law. Strictly speaking, they are not contracts at all, because—unlike either express contracts or contracts implied in fact—they do not rest on the express or implied assent of the parties but are imposed by law to prevent injustice.

Examples:

(1) Where money is improperly received, there is an implied obligation to account for it.

(2) Where money is improperly paid, there is an implied obligation to return it.

(3) Where an infant contracts for necessities he is not, strictly speaking, liable on *his* contract for the agreed price, but on the contract implied by law for the reasonable value (sec. 137).

(4) See section 194, Example (1).

173. Executed and executory contracts. An *executed* contract is one that has already been performed; an *executory* contract, one not yet performed. If one party has performed and the other not, or if both have partly performed, the contract is partly executory and partly executed.

174. Bilateral and unilateral contracts. A contract consisting of an exchange of promises is said to be *bilateral*. A promise given for an act already done, or an act to be done without promise on the other side to do it, is termed a *unilateral* contract. (See sec. 145.) Strictly speaking, it is not a contract at all, since in the former case it is based on past

consideration (sec. 150), and in the latter it lacks mutuality (sec. 147).

175. Collective liability: joint *v.* joint and several contracts. Where two or more promisors obligate themselves on a contract as one so that they are liable together or not at all, the contract is *joint*. Where they obligate themselves both individually, and collectively as a unit, the contract is *joint and several*.

Example: Fifty persons sign an agreement, "We hereby agree," and so on. Such an obligation is joint, and in case of dispute all must be sued together, or none. If they signed, "We and each of us agree," or "I hereby agree," the contract would be joint and several: all, or *any one*, could be sued in case of dispute.

176. Valid, void, voidable, and enforceable contracts. A *valid* contract is one having all legal requisites. A *void* contract lacks one or more requisites to validity, hence is invalid. In a *voidable* contract, one of the parties may (if he wishes) avoid the contract on some ground, such as fraud, infancy, duress, and so on, but unless and until such contract is thus avoided, it remains valid. An *enforceable* contract is not necessarily the same as a valid contract: Many contracts are valid but unenforceable for some procedural reason (such as oral contracts required by law to be evidenced by a writing, or contracts outlawed by the statute of limitations).

177. Entire and divisible (severable) contracts. A contract is *entire* when all its parts are so interdependent that they must stand or fall together, so that failure or illegality of one part renders the whole invalid. A contract is *divisible* or *severable* when it is susceptible of division or apportionment, so that failure or illegality of one part does not destroy the whole. The test is usually whether a single consideration or price is fixed for the whole contract (in which case the contract is entire) or whether separate considerations are apportioned to the separate parts (in which case the contract is divisible).

Examples:

(1) Hecht buys from McCormick a team of horses for \$650, a set of harness for \$185 and a wagon for \$75. Before delivery, the harness is stolen. McCormick tenders the team and wagon, which Hecht rejects because of the missing harness. The rejection is unwarranted, because the contract is divisible: Hecht must accept the team and wagon, but may sue for breach as to the harness.

(2) In the Dempsey's Punch Bowl Case (sec. 159), where the contract

to alter premises was held illegal because it included unlicensed architectural services, plaintiff urged that its architectural services, if any, amounted only to about 5% or 10% of the entire services rendered. The court ruled, however, that "there is no means of segregating the good from the bad portions of the contract, in this case. The contract was entire and indivisible: to plan, construct and furnish a complete unit. If the plaintiff had sold the interior furnishings and decorations, the contract could have been separated at least to the extent of permitting recovery for the merchandise sold. Here however were only services, ideas and supervision. They cannot be separated into different classes—legal and illegal."

178. Form of contract. Although form is sometimes included among the contract requisites (sec. 106), a contract need not be in any particular form unless the statute so provides, as in the case of instruments required to be under seal or agreements required to be in writing.

A contract which lacks validity in itself does not acquire validity by being written or under seal: formality adds nothing to futility.

Example: A telephones B, "I have fine apples at \$5.00 a barrel." B says, "I will take two barrels." Since A's invitation to trade cannot be accepted as an offer (sec. 109), there is no contract. To cast this futility into a writing, with formal language, witnesses, seal, and so on, would not cure a failure of contract requisites (in this case, mutual assent).

From the standpoint and in the order of their formality, contracts are *of record*, *under seal*, and *parol* or *simple*.

179. Contracts of record. A contract of record is one entered into before some court "of record." Two leading examples are *judgments* and *recognizances*. A judgment is the official determination of a court of justice, but it is enforceable by execution only in the state where rendered. For the purpose of enforcing a judgment in another jurisdiction, it is treated as a contract. The most common form of recognizance is a *bail bond*.

180. Contracts under seal (specialties). A contract under seal, or *specialty* (also sometimes called a *covenant*) is a contract solemnized by adding to one's signature a seal ("L.S.," the word "seal," a disc, scroll or other symbol). Under the common law, such contracts possessed greater force than ordinary contracts, and this is still true, as we have seen, in various states today, particularly in respect to consideration (sec. 156) and the statute of limitations (see table on pages 44-45). The force of a seal, however, is on the wane.

The two most common types of specialties are *deeds* (sec. 1043) and *bonds* (sec. 280).

181. Parol or simple contracts. A parol or simple contract is one neither of record nor under seal. It may be oral, unless required by law to be evidenced by a writing.

C. Statute of Frauds

182. Nature, origin, and purpose. The "statute of frauds" is the name given to a group or collection of statutory provisions relating to agreements that are unenforceable unless evidenced by a memorandum in writing. The underlying purpose of the statute of frauds is to minimize the possibilities of fraud and perjury and to promote certainty in making and enforcing contracts. Memory is fallible; writings are specific. Hence the various states in this country have adopted statutes based upon the English statute of frauds, providing that no action may be brought on certain specified contracts unless the agreement upon which such action is brought, or some memorandum or note of it is in writing, signed by the party to be charged, or by some person authorized to sign it.

The English statute of frauds was adopted by Parliament in 1676. Its most important provisions were embodied in the fourth and seventeenth sections. The *fourth section* covered (a) contracts for more than one year, (b) contracts for the sale of realty, (c) contracts of guaranty and suretyship, (d) promises of executors or administrators to be personally liable for estate debts and (e) contracts in consideration of marriage. The *seventeenth section* covered contracts for the sale of personal property. These provisions have been adopted without substantial change throughout this country. Additional provisions have been adopted by the different states, requiring various other forms of agreements to be evidenced by a writing. These provisions are not uniform throughout the country. The more common ones are reflected in the New York statute. (See sec. 189.)

183. Contracts not to be performed within one year. A contract not to be performed within one year from the date of its *making* is unenforceable unless it is in writing and signed by the party to be charged.

One year to begin in future. A one-year oral contract made today but to begin next week is unenforceable because it cannot be performed within one year from the date of *making*.

No period specified: possibility of performance within year. A contract which fixes no definite time for performance but which is capable of performance within a year, need not be in writing; for example, an agreement to repurchase bonds "at any time buyer is in need of money," or to cut and deliver timber *within* two years. A contract for the maintenance, support or education of a person, for life or other indefinite period (without specifying a definite purpose the achievement of which would have to take more than a year) is deemed a contract possible of performance within a year, because of the possibility of death within the year.

No period specified: impossibility of performance within year. An oral agreement which specifies no period of performance but must of necessity take more than one year to perform is void.

Examples:

(1) An oral agreement involving educational training for a specific purpose that must of necessity take more than one year to achieve.⁵⁸

(2) An oral agreement to do something after the expiration of a written agreement that still has more than a year to go.

No period specified: improbability of performance within year. An oral contract which is possible of performance within one year is not void under the statute of frauds merely because it is not likely, or not expected, to be performed within that time, or even because it is probable that it will not be so performed. The question is not what the probable, expected, or actual performance of the contract may be, but whether, according to the reasonable interpretation of its terms, it requires that it should not be performed within the year.⁵⁹

Example: An oral agreement to pay a sum of money for life, payments to start within a year from the date of contract, is enforceable because, regardless of probabilities, death *might* come within the year.

No period specified: where parties clearly intend performance to take more than a year. Where the situation is such that the parties clearly intended the contract to take more than a year, an oral agreement is within the statute and void. The proof of intent is not on what the parties orally say they intended, but what the facts unmistakably show. Probability or improbability of performance within the year, as we have seen, is usually immaterial; but where the improbability "is so great or of such a character as to show unmistakably that the parties intended the agreement to last more than one year," the contract, if oral, is void.⁶⁰

Example: An agreement by a water company to furnish water to a village free of charge "so long as such waterworks exist."

184. Contracts for sale of realty. A contract for the sale of *any interest in* real property (except leases for not more than one year) must be evidenced by a writing. This includes not only land but also buildings, standing timber, growing crops,

⁵⁸ *Fitzgerald v. Upson*, 74 S.W. 2d 1061, affirmed 129 Tex. 211.

⁵⁹ 37 *Corpus Juris Secundum* 561.

⁶⁰ 37 *Corpus Juris Secundum* 562.

real fixtures (sec. 1025) and anything else annexed to land as part of the realty.

185. Contracts of guaranty and suretyship. An agreement to answer for another's debt, default or failure of duty, must be in writing to be enforceable.

Promise to "answer for" v. promise to pay. A promise to answer for another means that the latter is obligated in the first instance. If *A* says to *B*, "Let *C* have groceries and I will pay if he does not," such promise is to *answer for C*, because *C* is liable in the first instance. But if *A* says, "Let *C* have groceries and I will pay," such promise, though oral, would be binding, because only *A* is liable: *C* is not liable at all.

186. Special promise by executor or administrator. If an executor or administrator promises that estate obligations will be met, such promise is in no way extraordinary: The law will enforce estate obligations in any event. But if an executor or administrator promises the creditors that he will personally make good their claims against the estate, such promise is unenforceable unless it is in writing.

187. Promises in consideration of marriage. A promise in consideration of marriage is unenforceable unless in writing. This does not mean mutual promises to marry, but an agreement the consideration of which is marriage. For instance, if *A* says to *B*, "If you will marry *C*, I will pay you \$50,000," and *B* marries *C*, *B* cannot recover on *A*'s promise unless it is in writing, since the promise was made in consideration of marriage.

188. Contracts for sale of personal property. An agreement to sell personal property ("goods, wares and merchandise"), including *choses in action* (sec. 1054) as well as tangibles, of a specific value or over, is unenforceable unless in writing. The maximum value at which oral contracts of sale are permissible varies in the different states as shown in the table on page 91.

Part delivery, part payment, or sale at auction: An oral contract to sell personalty may exceed the allowable maximum price, yet be enforceable under any of the following circumstances:

(a) Where, at the time of the contract, the buyer receives and accepts the whole or any part of the goods sold; or,

(b) Where, at the time of the contract, the buyer pays the whole or any part of the purchase price; or,

(c) Where, if the sale is by auction, the auctioneer at the time of the sale enters a memorandum in his sale book specifying the nature and price of the goods sold, the terms of sale, the name of the purchaser, and the name of the person on whose account the goods were sold.

State	Allowable Maximum	State	Allowable Maximum
Alabama.....	\$ 500*	Nebraska.....	\$ 500*
Arizona.....	500*	Nevada.....	50
Arkansas.....	30	New Hampshire.....	500*
California.....	500*	New Jersey.....	500*
Colorado.....	50	New Mexico.....	50
Connecticut.....	100	New York.....	50
Delaware.....	25	North Carolina.....	#
District of Columbia....	50	North Dakota.....	500*
Florida.....	†	Ohio.....	2500
Georgia.....	50	Oklahoma.....	50
Idaho.....	500*	Oregon.....	50
Illinois.....	500*	Pennsylvania.....	500*
Indiana.....	500*	Rhode Island.....	500*
Iowa.....	†	South Carolina.....	50
Kansas.....	#	South Dakota.....	500*
Kentucky.....	500*	Tennessee.....	500*
Louisiana.....	**	Texas.....	#
Maine.....	500*	Utah.....	500*
Maryland.....	50	Vermont.....	50
Massachusetts.....	500*	Virginia.....	#
Michigan.....	100	Washington.....	50
Minnesota.....	50	West Virginia.....	#
Mississippi.....	50	Wisconsin.....	50
Missouri.....	30	Wyoming.....	50
Montana.....	200		

* This is the maximum allowable under the Uniform Sales Act.

† Oral sales unenforceable regardless of value.

** No statutory limitation up to \$500; oral contracts over that amount provable by witnesses.

No statutory limitation; oral sales enforceable regardless of value.

Several articles at different prices. Where several articles are bought at different prices, each less than, but all together aggregating more than, the maximum price limit fixed by the statute of frauds, a writing is required if the various items are *part of the same transaction*; otherwise not.⁶¹

Examples:

(1) In *Baldey v. Parker*,⁶² defendant went into the plaintiff's shop and bargained for various articles. No one article was of the value of £10, but the total amount of the bill was £70. Some were severed from a larger bulk, and some were marked in order to satisfy the purchaser that the same were afterwards sent home to him. The court held that the various purchases were part of an entire transaction; that if it were not thus construed, "we should entirely defeat the object of the statute. For then persons intending to buy many articles at one time, amounting in the whole to a large price, might withdraw the case from the operation of the statute by making a separate bargain for each article."

⁶¹ *Weeks v. Crie*, 94 Me. 458, 48 A. 107, 80 Am.S.R. 410; *Standard Wall Paper Co. v. Towns*, 72 N.H. 324, 56 A. 744; *Wertheimer v. Klinger Mills, Inc.*, 216 Ind. 481, 25 N.E. 2d 246, 249.

⁶² 2 B. & C. 37.

(2) But in *Aldrich v. Pyatt*,⁶³ the court held that where several articles are purchased, the circumstances may show an intent to make *separate contracts*. In such a case, if the value of each article is less than the maximum prescribed by the statute of frauds, there need be no writing, acceptance, or payment to make the purchases enforceable.

Sale v. work, labor, and services. Where goods are manufactured by the seller especially for the buyer, and are not suitable for sale to others in the ordinary course of the seller's business, the transaction is treated, not as a contract of sale, but as one for work, labor or services (to which the statute of frauds does not apply).

Examples:

- (1) Order to have tailor make up a suit of clothes.
- (2) Furniture ordered in particular styles.
- (3) Contract to cut, shape, sew and make carpet for designated rooms.

189. Additional contracts governed by statute of frauds. In addition to the foregoing provisions of the statute of frauds, which are directly derived from the English statute, various new provisions have been added to the old ones rendering agreements unenforceable unless they are evidenced by a writing in each instance. These provisions vary in the different states, but the following requirements of the New York statute are typical:

Agreements not to be performed before the end of a lifetime. An oral agreement to bequeath property, to make a testamentary provision, or to do anything else which cannot be performed before the end of the life of the person making the promise, is unenforceable. The purpose of this provision is obvious. Suits for breach of contract to bequeath property, or to make a testamentary provision, are naturally brought against the estate of the person who is alleged to have made and violated the contract. Such person, at the time of the suit, has died: His mouth is stopped, and he cannot defend or dispute the claim that he made the promise sued on. By requiring a writing to prove such a promise, the law reduces the temptation to frauds and perjuries.

Examples:

- (1) An oral agreement between husband and wife regarding disposition of the proceeds of an insurance policy covering the husband's life.
- (2) An oral promise allegedly made by a decedent, that plaintiff would be compensated out of the proceeds of the decedent's estate for taking care of decedent's sister.

Contracts to establish a trust in real property, with the exception of *implied* or *resulting* trusts (sec. 1246), have always required a writing since the statute of frauds came into existence, inasmuch as such contracts concern an interest in real property. However, the statute of frauds in a num-

⁶³ 64 Barb. 391.

ber of states, including New York, now also covers contracts to establish a trust in personal property.

Contract to convey or assign trust in personal property. If I hold \$50,000 worth of securities in trust for you, an oral conveyance or assignment of your interest as beneficiary of that trust would be unenforceable.

Subsequent or new promise to pay debt discharged in bankruptcy. If a person, notwithstanding his discharge in bankruptcy, promises one of his creditors to pay a certain debt, such promise is unenforceable unless it is evidenced by a writing (sec. 152).

Subsequent or new promise to pay debt barred by the statute of limitations. If a person, notwithstanding that a certain debt he owes is outlawed by the statute of limitations, promises to pay the debt, such promise is unenforceable unless it is evidenced by a writing (sec. 152).

Agreement to modify or discharge sealed instrument. In states still recognizing the efficacy of a seal (see sec. 156 and sec. 225, Merger), an oral agreement to modify or discharge a contract under seal is ineffective, unless it has been executed.

Contracts to arbitrate a controversy between the parties must be in writing to be enforceable (sec. 249).

190. Form of memorandum; signature. No particular form of memorandum is prescribed by the statute of frauds.⁶⁴ The memorandum will suffice if it (a) sufficiently identifies the subject matter of the contract, (b) names or identifies the parties, (c) states the consideration, (d) embodies the terms of the contract and (e) contains the signature of the party to be charged or his duly authorized agent. The memorandum may consist of a single writing, or several writings, such as an exchange of letters or telegrams.⁶⁵ The memorandum may be very brief.

Examples:

(1) In *Page v. Cohen*,⁶⁶ a brief extract from the minutes of a lodge, signed by the Secretary, was held sufficient.

(2) In *Bayles v. Strong*,⁶⁷ the following was held a sufficient memorandum to charge the seller with an agreement to sell real property (that is, standing timber): "Setauket, N.Y., Feb. 14, 1901. Received from Thomas N. Bayles two hundred and twenty-five dollars for locust at Oakwood. Selah B. Strong." It will be noted that this latter memorandum designated the subject matter, named the parties, stated the consideration, set forth the terms (obviously cash), and was signed by the party to be charged.

⁶⁴ *Bartlett-Heard Land & Cattle Co. v. Harris*, 28 Ariz. 497, 238 P. 327; *Goetz v. Hubbell*, 66 N.D. 491, 266 N.W. 836.

⁶⁵ *Fey v. Loose-Wiles Biscuit Co.*, 147 Kan. 31, 75 P. 2d 810, 813.

⁶⁶ 80 Misc. 237.

⁶⁷ 104 App. Div. 153.

The writing need not be signed by both parties, but only by the one to be charged. (See sec. 1382, subd. c.) If both are to be charged, both must sign, since the right of action is against only the one or ones who sign. The signature, in most states, need not be at the end. It must, however, clearly be intended as a signature of the party to be charged. (For an example, see sec. 1415.)

191. Writing must show all the terms. The writing must *fully* embody the terms of the contract.⁶⁸ If it omits any material part of the understanding, it is insufficient to satisfy the statute of frauds.

Example: Berman orally ordered of Hirsh 2250 men's suits of various sizes, styles, materials and prices. The oral agreement further stipulated terms of shipment and delivery. Hirsh signed a written memorandum specifying the number, sizes, styles, materials and prices, but omitted reference to shipment and delivery. In a suit for breach of contract, Hirsh successfully pleaded the statute of frauds, because the written memorandum did not embody all the terms of the understanding.⁶⁹

192. Equity and the statute of frauds: part performance of land contract. Equity will not permit the statute of frauds to be utilized as an instrument for achieving a fraudulent or inequitable result. Hence, where an oral agreement to sell real property has been partly performed (as where the buyer has paid part of the price, taken possession and made improvements), equity will compel specific performance, and the seller will be compelled to deliver the deed.

193. Full performance by one of the parties. The doctrine of part performance is a creature of equity and applies only to land contracts. In all other oral contracts governed by the statute of frauds, there must be full performance by one of the parties to compel performance by the other.

194. Unjust enrichment. Even where the contract does not concern real property and where one of the parties has only partly performed under an oral contract governed by the statute of frauds, the law will not permit the other party to be un-

⁶⁸ *Santoro v. Mack*, 108 Conn. 683, 145 A. 273; *F. & W. Grand Five-Ten-Twenty-Five Cent Stores v. Eiseman*, 160 Ga. 321, 127 S.E. 872; *Gaskill v. Jacobs*, 38 Idaho 795, 225 P. 499; *Patterson v. Beard*, 227 Iowa 401, 288 N.W. 414, 125 A.L.R. 393; *Cassity v. Cassity*, 147 Kan. 411, 76 P. 2d 862; *Farrell v. Simons*, 180 Okl. 600, 71 P. 2d 688.

⁶⁹ *Berman Stores v. Hirsh*, 208 App. Div. 622 (reversed on evidentiary grounds, 240 N.Y. 209).

justly enriched by pleading the statute; and this is all the more so where one of the parties has fully performed.

Examples:

(1) If I pay you \$100 as a deposit on a two-year, oral contract, you may refuse performance by pleading the statute, but the law will imply a promise on your part to repay me the amount of my deposit. (See sec. 172, "Quasi contracts.")

(2) If a farm hand is orally hired for eighteen months and discharged without pay at the end of a month, the fact that the contract is oral will not defeat the employee's right to recover the reasonable value of his services.

(3) Money loaned to enable the borrower to complete a university course, under an oral promise to repay after the borrower has started to earn money by practicing his profession, may be recovered regardless of the statute of frauds on a promise to repay implied by law. (See section 1519.)

195. Parol evidence rule. Once parties have reduced an oral agreement to writing, they are bound by the writing and are not allowed to offer any proof of the oral agreement contradicting the terms of the writing. This rule has four exceptions:

(1) *Oral proof of invalidity* does not merely contradict a writing; it goes to the existence of a written contract and destroys it. For example, oral proof showing fraud, mutual mistake, lack of consideration, duress or illegality, would have the effect, not of altering or varying the written contract, but of showing that *there was no contract really in existence*.

(2) *Oral proof of a condition precedent*, that is, that the parties orally agreed that a certain condition was to have been fulfilled before the written agreement was to become effective, is permissible. To establish oral proof of such a condition, and its nonfulfillment, would also be, not to vary the terms of a written contract, but to show that there was really no contract in existence, since its existence depended upon the fulfillment of the condition.

(3) *Oral proof to clear up ambiguity, omissions, or obscurity* is not only permissible, but necessary. If a contract contains words that might mean one of several things, there is no way to prove what was really intended, except by oral evidence. The same applies to omissions in a contract, or to portions that are blurred, erased, or obscure in meaning.

(4) *Oral proof of subsequent modification upon consideration* is permissible. If you and I enter into a written agreement, and subsequently, without consideration, we orally agree to modify the terms of the written agreement, this subsequent oral agreement, lacking consideration, is no contract at all, and leaves the written agreement unaffected. But if such oral agreement is upon consideration, it is a valid contract. Its subject matter is to modify a prior written agreement. Written contracts (except

those required to be in writing under the statute of frauds) may thus be modified or discharged at will by mutual agreement of the parties, even though such mutual agreement be oral, provided there is consideration for the contract of modification or discharge.

D. Operation and Effect of Contracts

196. Construction and interpretation of contracts. The operation and effect of a contract often depend upon judicial interpretation and construction, particularly where the meaning of a contract is in dispute. The following rules of construction and interpretation have been laid down by the courts:

(a) The object of the courts is to ascertain the *true intent* of the parties from what was *actually said or written*.

(b) Ordinary words are interpreted in their ordinary grammatical sense, except where such interpretation would be absurd. For example, where a policy of insurance on a stock of goods in a store provides that the policy is to become null and void "if the said property shall be sold and conveyed," it would be absurd to give the words "sold and conveyed" their ordinary grammatical meaning, because the purpose of the store is to sell merchandise. The kind of sale referred to in the policy was obviously a sale of the store.

(c) Technical and trade words are given their technical and trade meaning.

(d) Where handwritten and typewritten words conflict, the handwriting prevails; where typewritten and printed words conflict, the typewriting prevails; where words and figures conflict, the words prevail.

(e) Where one construction will make a contract legal and the other not, the parties will be presumed to have intended a legal contract. For an example, see section 158, the "put" and "call" case (*Story v. Salomon*). The court in that case said that if the contract could be construed *either* as legal or as a gamble, the court would presume that the parties intended to obey the law.

(f) Ambiguous words will be construed against the party who drew the contract and selected the words. Thus, if a clause in an insurance policy may be construed two ways, one in favor of the company, which drew the contract, and another in favor of the policyholder, the latter construction will prevail.

(g) If general words are followed by specific, the specific will control, as if the general words had not been used at all.

Examples:

(1) If a contract reads, "performance is excused in case of fire, flood, hurricanes, tornadoes or other conditions beyond our control," the general words "or other conditions beyond our control" are limited by the specific words "fire, flood, hurricanes, tornadoes," and only contingencies of the latter nature will excuse performance, so that if the actual contingency that arises to prevent performance is a strike, it will not excuse performance.

(2) Where, in a building contract on a cost-plus basis, "direct expenses"

are defined to include certain specific items (among them, employee's compensation and public liability insurance), the contractor has no right to include premiums on fire insurance, though such cost would ordinarily be part of direct overhead expenses.

(h) Where no time is specified for payment under a contract, performance is a prerequisite to payment. Thus, in the absence of other provision, the law would require the last payment under a building contract to be made upon completion.

(i) A contract containing no provision for termination is terminable at will. (See sec. 1418.)

197. Different jurisdictions: which law governs. When a contract is made in one state and sued on in another, all questions involving the validity of the contract itself are governed by the law of the state where the contract was made and to be performed, and all questions involving remedies, procedure, and so on, are governed by the law of the state where suit is brought. When a contract is made in one state but is to be performed in another, many states⁷⁰ hold that the law which governs the validity of the contract is the law of the state where the contract was to have been performed. Parties to a contract may stipulate as to the law of which state shall govern in case of dispute. (See sec. 1059.)

198. Contract obligations: duty not to interfere. Ordinarily, only the parties to a contract are obligated by its terms. However, any person who induces a party to violate the terms of his contract is liable to the other party for *tortious interference with contract* (sec. 30, subd. "Tortious interference with contracts" and sec. 167).

199. Contract rights of outside and subsequent parties. Under the common law, only the parties to a contract were interested in it, and only a party to a contract could sue on it. These limitations have been broadened so that parties may acquire contract rights (a) as third party beneficiaries and (b) as undisclosed principals. Subsequent parties, also, may acquire an interest in a contract, as by: (c) operation of law, (d) assignment, (e) negotiation and (f) novation.

200. Third party beneficiaries. It is the rule in a majority of the states⁷¹ that if I make you a promise *for the benefit of a*

⁷⁰ Among them, the following: Arkansas, Georgia, Illinois, Iowa, Kentucky, Michigan, Missouri, Nebraska, New York, Oklahoma, Pennsylvania, Washington, and Wyoming.

⁷¹ Including Alabama, Arkansas, California, Colorado, Connecticut, Florida, Illinois, Indiana, Iowa, Kansas, Kentucky, Mississippi, Missouri, Nebraska,

third party, the latter, though not a party to our contract, may hold me to my promise, *provided you (the promisee) are obligated to him*.

Examples:

(1) Holly lent Fox \$300, on Fox's promise to repay that amount to Lawrence, to whom Holly owed that sum. On Fox's failure to repay the amount as promised, Lawrence sued Fox, whose defense was that he made no promise to *Lawrence*. The court held Fox liable, because (a) Holly, to whom Fox made the promise, was obligated to Lawrence and (b) the promise was made for the benefit of Lawrence.⁷²

(2) A, who contemplates buying a home from X, a realtor, asks X to get a new tenant for A's apartment. X procures B. The landlord promises B that he will pay the realtor's commission. Such promise, *made to B*, is not binding, since B is not obligated to the realtor.

(3) Morgan, a patent attorney, rendered services to Forbes on patent applications for a cigarette cut-off device. Thereafter Forbes gave Ebco Machine Corporation the right to manufacture the device, and the Corporation, without mentioning Morgan's name, agreed to pay for future legal services in prosecuting the patent applications. Morgan, with knowledge of this agreement, continued to render services on the patent applications, for which he later billed the Corporation. The Corporation refusing to pay, Morgan sued. The court, in dismissing the complaint, pointed out that an outside third party has no right to sue on a contract unless it is made for his benefit, and that this contract was solely for the benefit of Forbes, not Morgan or any other third party.⁷³

201. Undisclosed principals. If I, representing an undisclosed principal, make a contract with you, my undisclosed principal may step forward at any time and claim the benefit of the contract; and you, on the other hand, upon disclosure of the principal, may elect to hold him. To this rule there are certain exceptions discussed in the chapter "Agency" (sec. 570). If a person wants to make sure that he is not dealing with an undisclosed principal, he may so provide in the contract.

202. Subsequent parties in general. Persons subsequent to the original parties may acquire an interest in a contract and become subject to its obligations. Frequently, contracts so provide, though the law generally implies it in the absence of such provisions; for example: "This contract shall inure to the

New Jersey, New York, North Carolina, Ohio, Oregon, Pennsylvania, Tennessee, Texas, Utah, Wisconsin and Wyoming.

⁷² *Lawrence v. Fox*, 20 N.Y. 286.

⁷³ *Morgan v. Ebco Machine Corporation*, 239 App. Div. 346, 267 N.Y. Supp. 369.

benefit of, and be binding upon the parties hereto, *their heirs, executors, administrators and assigns.*"

Privity of contract is said to exist between two or more parties or their successors when such parties have an enforceable right or liability in respect to one another by reason of such contract.

203. Subsequent parties by operation of law. In case a person dies, or goes into bankruptcy, his personal representatives acquire his contract rights and discharge his contract obligations.

Death. If the decedent has left a will in which he has named an executor, the latter, as personal representative for the estate, acquires the decedent's contract rights and discharges his contract obligations. If the decedent has left no will, his administrator (sec. 1181) serves as personal representative. Personal contracts (promises to marry, to render personal services, and so on) die with the person; other contracts survive.

Example: If a decedent had made a contract with X to deliver 1000 bushels of wheat at \$1.00 a bushel, X could compel the decedent's personal representatives to fulfill the contract or pay damages out of the decedent's assets; and if the decedent had delivered the wheat but had not been paid, his personal representatives could compel payment.

Bankruptcy. If a person goes into bankruptcy, his assets, including his contract rights, are acquired, through operation of law, by the trustee in bankruptcy (sec. 1282).

204. Assignment: nature and parties. To *assign* a contract is to transfer one's rights under it. Such transfer may be effected, (a) by act of parties, as where one person transfers his contract rights to another and (b) by operation of law, as in the case of death or bankruptcy (sec. 203).

The party who transfers his rights is the *assignor*; the party to whom they are transferred, the *assignee*.

Assignment v. agreement to assign. An assignment is an executed transfer. It corresponds to a gift. An agreement to assign is a contract. It is unenforceable in the absence of any contract requisite. However, assignments, like gifts, may be invalid under certain conditions.

205. Assignment: form and requisites. An assignment need not be in any form. It may be oral; or it may be indicated by indorsing on the contract, "Assigned," with the assignor's signature or initials; or it may be in more formal terms. Unless required by statute, a written assignment need not be signed, provided it is accepted and acted upon.

An assignment, like a gift, requires no consideration. It

must, however, effect a *present transfer* to a *specific assignee* in existence.

Example: An assignment of War Bonds to a corporation not yet in existence effects no present transfer and is invalid.

206. Rights of assignee. An assignee acquires only such rights as the assignor has and is subject to any defenses which the other party to the contract might have urged against the assignor.

Examples:

(1) If I agree to sell you a carload of grain for \$1000, you may transfer your rights under the contract to Robinson, who acquires, by assignment, the same rights you had to compel me to deliver the carload of grain for \$1000; or I may transfer my contract to Franklin, who thus acquires, by assignment, the right to compel you to pay \$1000 for a carload of grain.

(2) If in making the above contract you were guilty of fraud, duress or similar conduct giving me a defense against you should you sue me for non-performance, I can urge the same defense against Robinson or any subsequent assignee, because you cannot assign any greater rights than you possess; and the same would apply to you and your assignee if I had been guilty of similar misconduct in making the contract with you.

(3) If *A* owes *B* money, and assigns a lease to secure the debt, *B* as assignee gets no greater rights under the lease than *A*. Like *A*, *B* takes the lease subject to all its terms, covenants and conditions.

Assignee's right to sue. Formerly, an assignee had to sue in the assignor's name. This is no longer true.

207. Obligations of assignor and assignee. In the ordinary assignment, the assignor, as an original party to the contract, remains liable for its performance, and the assignee merely acquires the assignor's rights (subject to any defenses), without himself becoming liable for performance, because there is no *privity* between him and the other party to the contract; that is, they are "contract strangers" to each other.

Assumption v. assignment. If the assignee assumes the contract, he is liable, because in effect he is making a promise to the assignor for the benefit of the other party to the contract, to whom the assignor is obligated (see Third Party Beneficiaries, sec. 200).

Example: If, in the example given in section 206, Robinson also agreed to *accept* the grain, or if Franklin agreed to *deliver* the grain, we would have an assumption as well as an assignment; and the assignee in each case would be liable as well as the assignor.

208. Liabilities not assignable. If, by contract, I become obligated to you for \$500, I cannot, without your consent, shuffle off such obligation by transferring it to Brown. If I

attempt to do so, I remain personally liable so far as you are concerned, unless you consent to the arrangement, in which case we have a *novation* (see sec. 212).

209. What contracts assignable. Generally speaking, all mercantile contracts are assignable. For example, if *A* agrees to sell *B* 200 drums of oil, with deliveries at the rate of two drums a day and *B* then sells his business to *C* before the drums are fully delivered, *A* has no right to refuse further deliveries because of the transfer. However, to the rule that all contracts are generally assignable, there are certain exceptions:

(a) *Contracts creating a personal relationship*, such as a contract to marry, a contract of agency, partnership or guaranty, or a contract to render personal services.

(b) *Contracts prohibiting assignment*, or containing provisions that they cannot be assigned without consent of the other party. Nonassignability clauses must be clearly expressed in a mercantile contract; courts will not stretch an inference of nonassignability. (See sec. 1423 for an illustration.)

(c) *Illegality of contract*, or of a coupon or certificate issued in connection with it, such as sweepstake tickets or, in some states (see sec. 1423), coupon certificates.

210. Notice of assignment. If a creditor assigns an account, the assignee should notify the debtor promptly of the assignment; otherwise, should the debtor, ignorant of the assignment, pay his creditor and should the creditor then disappear, the assignee would have no remedy.

211. Subsequent parties: negotiation. A contract obligation in the form of a negotiable instrument is transferable by indorsement and delivery or, where the obligation is to bearer, by delivery alone. An assignee, as we have noted, takes subject to all defenses available against the assignor (sec. 206), but this is not true where rights in commercial paper pass by negotiation to innocent third parties. This subject is more fully discussed in sections 260-261.

212. Novation. Novation is the substitution of a new contract, or a new debtor or obligor, for an existing one. In reality it is a contract consisting of two stipulations; one to extinguish an existing obligation or to release an existing debtor, the other to substitute a new one in place of the old. Since novation creates a new contract, it requires the assent of both parties to the original contract. This is what is really meant by the statement that liabilities cannot be assigned (sec. 208).

Example: *A* is obligated to *X* by contract. He may not, without *X*'s consent, shift his obligation to *B*, even though *B* is willing to assume it. If, however, *X* consents to release *A* upon condition that *B* assume the obligation, a novation takes place. The consideration supporting such new contract or novation is the obligation assumed by *B* in place of *A*.

Four elements must be present to constitute a novation: (1) a previous valid obligation, (2) agreement of all parties to the new contract, (3) extinguishment of the old contract, and (4) validity of the new one.

E. Discharge of Contracts

213. **How contracts may be discharged.** Contracts may be discharged by performance, agreement, impossibility, operation of law, alteration and breach.

214. **Discharge by performance, generally.** Questions most frequently arising in connection with the performance of contract are: (a) time of performance, (b) satisfactory performance, (c) performance by payment and (d) tender of performance.

215. **Time of performance.** If a contract specifies no time for performance, it must be performed within a reasonable time. What constitutes a reasonable time depends on the circumstances. If the contract specifies a time for performance, it must be performed within that time; if not, the other party may offset, against payment, any damage caused by the delay, or if time is "of the essence," he may reject performance entirely.

Time of the essence. Time is "of the essence" when failure to perform on time gives the other party a right to cancel the contract. At common law, time was presumed to be of the essence. In equity and by the modern rule, the presumption is the other way around unless (1) the parties clearly stipulate that time is of the essence, or (2) where it is evident that nonperformance within the time fixed will defeat the purpose of the contract (as in the case of merchandise ordered for a voyage and not delivered until after departure).

216. **Satisfactory performance: in general.** In the absence of specific provision, performance is deemed satisfactory if it should satisfy the ordinary, reasonable person under the circumstances. This is a question of fact in each case, to be determined by a jury.

217. **Satisfactory performance: compliance with conditions.** Performance of a contract, to be satisfactory, must comply

with its conditions. Conditions may be *precedent*, *subsequent*, and *concurrent*.

Conditions precedent are those that must either come to pass, or be performed by the other party, before a party is required to perform.

Conditions subsequent are those that follow performance and must be complied with by the party on whom they are imposed, else his rights and benefits under the contract will be defeated or impaired.

Conditions concurrent are those that are mutually dependent and are to be performed at the same time. Examples: simultaneous contributions of capital investment between prospective partners as conditions for the creation of the firm; simultaneous delivery and payment as conditions for a sale.

218. Satisfaction guaranteed. Where a party guarantees satisfaction, the other party must be reasonable in protesting dissatisfaction, unless performance involves personal taste, fancy or judgment. In the latter situation, the question is not whether the other party's taste, fancy or judgment are reasonable, but whether they are real or spurious; that is, whether they are urged in good faith. Some jurisdictions go further and hold that one must not be capricious in exercising his judgment, taste or fancy; but the weight of authority is that when *A* agrees to perform a contract to *B*'s satisfaction and the work involves personal judgment, taste, fancy, and so on, *B* has an arbitrary right to reject performance. Certainly where *B*'s judgment is neither spurious nor capricious, he may reject performance regardless of what the ordinary reasonable person might have done under like circumstances.

Examples:

(1) If one agrees to paint a portrait, do a bust, design a dress or fit a suit of clothes to another's satisfaction and the latter is dissatisfied, the law will not inquire into the reasonableness of such dissatisfaction.

(2) In a contract between The Printing Company and The Cook Company on a cost-plus basis, cost is defined as including various items, among them administrative and overhead charges "satisfactory to The Cook Company, which said sum is to be determined by The Cook Company after an audit and examination by The Cook Company." After an audit, The Cook Company notified The Printing Company that the latter's overhead charges were not satisfactory. The dissatisfaction was actual, not capricious, but based on points in dispute among leading accountants. The contract therefore obviously involved a matter of judgment, and The Cook Company's dissatisfaction alone was sufficient ground for rejection. (See sec. 1424.)

219. Performance to third party's satisfaction. Parties may agree that performance shall be to the satisfaction of an outsider, such as an architect (in building contracts), an umpire, judge, arbitrator or referee. In such cases, performance must satisfy such third party or there is no liability, unless fraud or collusion can be shown in arriving at a decision.

220. Substantial performance. Under the common law, performance of an express contract had to be complete to the last detail or one could not recover on the contract but had to resort to the doubtful remedy of a suit based on an implied contract. This frequently resulted in hardship, and in the course of time the rule was superseded by the doctrine of "substantial performance": that if (a) a *bona fide* effort is made toward full compliance with the terms of the contract, (b) there has been no wilful or intentional departure from such terms and (c) the deviations, defects or omissions are minor only, recovery will be allowed for substantial performance, with an offset for any damage sustained because of such deviations, defects or omissions.

Example: Smith, a contractor, alters and repairs Brown's store, but Brown refuses to pay him because certain doors are not well hung and one door does not fit its casing; otherwise, the job is well done. The court would allow recovery in such case under the doctrine of substantial performance, with a setoff to Brown for the reasonable value of curing the defects.

221. Performance by payment. Numerous questions arise in connection with the performance of a contract by payment. These have been largely settled by the courts.

Debt defined. A debt is a sum of money due upon contract, express or implied.

Payment: when due. Payment agreed to be made at a particular time is due then. When no time is fixed, payment is due immediately on demand, or within a reasonable time. When a debt is payable within a specified term, it is not due until the last day of the term.

Payment: place where due. If payment is tendered at the wrong place, drastic legal consequences may ensue, as where an installment contract provides that if any installment is not paid when due, the entire unpaid balance becomes due; or where the full amount of a mortgage may fall due in case interest is not paid on or by a given date. The following rules are therefore important:

(1) Parties may agree by contract on where payment shall be made; in such case, payment must be made there.

(2) If parties have not agreed on the place of payment, a debt is pay-

able where the creditor resides, or has his place of business, or wherever he may be found.

(3) It is ordinarily the duty of the debtor to seek the creditor for the purpose of making payment.

(4) If a contract is made outside the debtor's state, it will be presumed (in the absence of agreement) that payment is due there.

(5) If the contract is made in the debtor's state, he is not obliged to seek his creditor outside the state, but the latter must arrange to receive payment in the debtor's state.

Medium of payment. A debt must be paid in legal tender (sec. 222) if the creditor insists. The medium of payment is frequently stipulated: by money, or by credit instrument, such as check, draft, note, trade acceptance or similar instrument; this depends on the terms of the contract. If the contract requires payment in money, only such payment will extinguish the debt, unless the requirement is waived and a substitute accepted. If the contract is silent on the medium of payment, payment in money is usually implied. If, instead, a check is given in payment, and it is neither actually nor impliedly accepted as payment, the law presumes that the acceptance is conditional only; so that if the check is not paid, the original debt survives. But a creditor may impliedly (and sometimes unwittingly) accept a check as payment; for example, where, on receiving a check, he acknowledges "receipt of your check *in payment*," or where he negotiates the check to someone else. If a check is accepted as payment, either expressly, impliedly, or by waiver of money payment, and the check is not paid when presented, the creditor must sue on the check, since the original debt is deemed discharged by acceptance of the check. If the check is lost, the creditor is at a disadvantage in proving his case.

Where a creditor accepts a check as conditional payment, subject to collection, he must not unreasonably delay presenting the check for payment. If he does, and the bank has become insolvent in the meantime, the consequent loss falls on the creditor.

Certified checks. Certified checks are not substitutes for money, unless the parties agree to accept them as such. When a debtor sends a certified check in payment of a debt, which the creditor has not expressly agreed to accept as payment, and the bank becomes insolvent before the check is paid, the loss falls on the debtor. But where the debtor sends his *uncertified* check in payment, and the *creditor* has it certified, he thereby accepts the certification as payment, and in case the bank becomes insolvent before the check is paid, the loss is the creditor's.

Cashier's check. Where a creditor accepts a cashier's check as payment, and the bank fails, the creditor has no further claim against the debtor. (For an illustration, see section 1432.)

Promissory notes. When a debtor gives his own promissory note in payment of a debt, the same rule applies as that governing payment by check, that is, it is not deemed payment unless specifically or impliedly accepted as such. If the note is paid, the debt is discharged; if not, the original debt survives. If the note is accepted as payment, and when due, it is not paid, the creditor must sue on the note, not on the original debt, and if the note is lost, the creditor is at a disadvantage in proving his case.

A somewhat different principle applies, however, when a debtor gives the note, check or draft of a *third person* in payment of a debt. In such a case, if the debt was incurred before the instrument was given, the rule is the same as if the instrument were made by the debtor himself, that is, payment is conditional unless otherwise agreed. But if such instrument is given *at the same time the debt is incurred*, the law will presume that it was accepted as unconditional payment, so that if the instrument is not paid, the creditor must sue on the instrument itself, since the original debt was discharged.

Payment by mail. If a debtor sends money by mail to pay a debt, he does so at his own risk, unless directed to do so by the creditor.

Where payment is made by mail, it is not effective unless received. Hence if payment is due on a given date (for example, an insurance premium), and the debtor remits by mail, he is in default if the remittance is lost in the mails, or if delivery is delayed beyond the due date.

Exceptions: (1) Where the creditor expressly or impliedly directs or consents that payment be made by mail; or (2) where payment by mail is according to the usual course of dealing between the parties, from which creditor's assent to such remittance may be inferred. (See secs. 946, 1727.)

Application of payments: principal and interest. "Where partial payments are made, the rule is to apply the payments in the first place to the discharge of the interest then due. If the payment exceeds the interest then due, the surplus goes toward discharging the principal, and interest is to be computed thereafter on the balance of the principal. If the payment is less than the interest, the surplus of interest must not be taken to augment the principal, but interest continues on the former principal until the payments, taken together, exceed the interest due, and then the surplus is to be applied toward discharging the principal, and interest is to be computed on the balance of the principal as before."⁷⁴

Application of payments to different accounts. Where a debtor owes several debts to the same creditor, the following rules govern payments on account:

(1) "A debtor paying money to a creditor to whom he owes several debts may direct the application of the payment because the money is his and he may do as he will with it and control its application. But the debtor must exercise his option as to the application when he makes the payment. After that the money has ceased to be his and is no longer subject to his control. Then it belongs to the creditor, and he is master of it, and may control its application."⁷⁵

Therefore, when a debtor owes several debts to the same creditor, and makes a payment on account, he should specify to which account he wants the payment applied. Otherwise, the creditor may apply it to whichever

⁷⁴ 33 *Corpus Juris* 250.

⁷⁵ *Bank of California v. Webb, et al.*, 94 N.Y. 467, 472. To the same effect: *Lazarus v. Freidheim*, 51 Ark. 371, 11 S.W. 518; *Huffman v. Cauble*, 86 Ind. 591; *Thomas v. Beaufort Bank*, 183 N.C. 508, 112 S.E. 27; *Fargo First Nat. Bank v. Roberts*, 2 N.D. 195, 49 N.W. 722; *Baum v. Trantham*, 42 S.C. 104, 19 S.C. 973, 46 Am.S.R. 697.

account he prefers; and if one of the accounts bears no interest and the others do, he will be likely, in the absence of direction from the debtor, to apply the payment to the noninterest-bearing account.

(2) The creditor need not specify immediately to which account he intends to apply the payment; he has a reasonable time in which to do this. He must make his election, however, before controversy and suit on the subject.

(3) After appropriation is made, it cannot be changed, except (a) with the consent of the debtor, (b) for fraud of the debtor, or (c) where the wrong account has clearly been credited in error.

(4) Where payments are made on open account and neither debtor nor creditor designates or applies the payment to any given item, the law will presume that it is to be applied to the earliest item of the account,⁷⁶ though a court may make any disposition which accords with "intrinsic equity and justice."⁷⁷

(5) The following may constitute evidence showing to which account the creditor has applied the payment: (a) notice to debtor, (b) entries on the creditor's books, (c) subsequent statements of account rendered by the creditor, (d) creditor's demands upon commencement of suit. Any of these would bind the creditor and bar him from subsequently contending that he had applied the payment differently.

(6) A creditor is not ordinarily required to notify the debtor of his election, unless (a) he wishes to place himself on record, or (b) the debtor requests such notice. Subsequent statements rendered by the creditor would constitute notice of his election.

222. Tender of performance. Tender is an offer to do what one is required to do under a contract. When it squares unconditionally⁷⁸ with the requirements of a contract, it is "good tender," but if it deviates from the contract in any respect, it is not. Tender is necessary where acts to be performed are mutual and dependent. It enables the tendering party, in case of breach, to show that he was ready to do his part, and it places the other party more clearly in default.

Tender is not good if coupled with demand for a receipt. If a seller makes a partial tender, the buyer is not bound to sever the tender, take what is due and reject what is nontenderable, but may reject the improper tender in its entirety.

Example: By contract between *H* and *C*, *H* agrees to sell fifty warps of cotton yarn, deliveries 10% weekly. *H* makes one delivery of eight warps, then suspends delivery for eight weeks because of an embargo, then ships the remaining forty-two warps, which *C* refuses to accept. *C*'s rejection of the tender was sustained by the court.⁷⁹

⁷⁶ *Lehigh Coal, etc. Co. v. McLeod*, 114 Me. 427, 96 A. 736; *Smith v. Lewiston Steam Mill*, 66 N.H. 613, 34 A. 153; *Huger v. Bocquet*, 1 S.C.L. 497.

⁷⁷ *Camp v. Smith*, 136 N.Y. 187.

⁷⁸ *Hanlon v. Manger*, 85 Mont. 31, 277 P. 433.

⁷⁹ *Herx & Eddy v. Carlson*, 210 A.D. 417.

Legal tender is money a creditor must accept in payment of a debt. Congress determines what coins and notes constitute legal tender. Prior to 1933 legal tender consisted of nickels and copper coins up to twenty-five cents, dimes, quarters or half dollars up to ten dollars, and gold coins, silver dollars, United States notes, gold certificates and United States Treasury notes to any amount. By various acts in 1933, Congress caused all gold coins and gold certificates to be withdrawn from circulation and made all other existing coins and currency, together with Federal Reserve and National Bank notes, legal tender for the payment of private debts to any amount.

223. Discharge by agreement. Parties may "agree to disagree," that is, to sever their contract relationship. This may be done by the terms of the original agreement or by subsequent agreement; and in the latter event, (a) by modification, novation or merger, (b) by cancellation and release or (c) by accord and satisfaction.

224. Discharge by original agreement. A contract may provide by its own terms for its own discharge upon certain contingencies; as, that it shall be automatically discharged by unauthorized assignment, by failure to comply with certain conditions, by labor disputes, or by *force majeure* (contingencies beyond human control).

225. Discharge by modification, novation, merger. Parties to an unperformed contract may, upon mutual assent, consideration and the other contract essentials, modify an existing contract in any respect. When they do so, they thereby discharge the old terms as thus modified.

Novation is similar to modification, except that novation imports the substitution of a substantially new contract or new parties (sec. 212). The effect, however, is the same: to discharge the superseded terms or parties.

Merger takes place (in the contract sense of the term) when one form of contract is superseded by another form of *the same contract*. For example, if an oral agreement is superseded by a writing, or an unsealed written agreement by one under seal (the terms of the contract remaining unchanged), the earlier contract is said to be *merged* into the later one. A reversal of this process formerly was regarded as legally ineffective. For example, a written contract could not be discharged by an oral one, or a contract under seal by an unsealed writing. It is now generally recognized (except in those states which still attach importance to a seal) that this is no longer the rule, provided the later contract is supported by consideration. In many states, the old rule is abolished by statute. In New York, for example, the statute provides that "A written instrument . . . which changes or modifies or which discharges . . . a sealed instrument shall not be declared invalid or ineffectual because of the absence of a seal thereon."

Example: *M*, by a sealed instrument, assigns to *G* a one-half interest

which *M* has in a construction contract. *G* agrees to bear one half the cost of completion. Subsequently *M* and *G*, by a contract not under seal, cancel the assignment and *G*'s obligation thereunder. *M* completes the job, and upon *G*'s death, sues *G*'s estate for one half the cost of completion under the original contract. *M*'s suit must fail: his agreement with *G* was validly discharged.

226. Cancellation and release. Either party to a contract, for cause, may cancel or rescind it, and both parties, by mutual assent, may terminate it and release each other from further obligations under it.

A *release* is an instrument discharging an obligation. It is often, but not necessarily, under seal, except in those states which still recognize the common law efficacy of a seal. If the release discharges all claims of whatsoever nature, it is known as a *general release*.

A *mutual release* is a discharge by each of two or more parties to the other or others, the consideration for each discharge being the discharge or discharges given by the others.

Release and receipt distinguished. A release extinguishes a right. A receipt is merely an admission. The person obtaining such admission has a right to assume that it is correct unless the contrary is proved, and the burden of proving the contrary is on the signer of the receipt. "As otherwise stated, a receipt is evidence that an obligation has been discharged, but a release is itself a discharge of it; a receipt is only *evidence* that a debt has been paid, whereas a release is the extinguisher itself."⁸⁰ A release, once given, cannot be disturbed except for fraud, mutual mistake, or duress; a receipt, being merely evidence, may, if it is incorrect, be contradicted by the true facts, whatever they are, unless the signer who seeks to contradict his admission is estopped (sec. 103) from so doing.

Release without consideration. Under the common law a release, being necessarily under seal, could not be questioned for lack of consideration. In states which have abolished the common law sanctity of a seal, releases became exposed to challenge for lack of consideration. As against this, statutes have been passed rendering a release in writing, with or without seal, binding regardless of consideration.⁸¹

227. Discharge by accord and satisfaction. An *accord* is an agreement between parties to a dispute, to accept a new arrangement in place of the disputed one. It often takes the form of agreeing upon a given sum as due, in place of conflicting claims on the amount due. When the accord is carried out, it is said to be *satisfied*. There must be a *genuine dispute*

⁸⁰ 53 *Corpus Juris* 1197.

⁸¹ For example, the New York statute provides that an agreement to change, modify or *discharge* an obligation shall not be invalid because of the absence of consideration, provided the agreement or release is in writing, signed by the party to be bound.

about an *unliquidated claim*, or the accord and satisfaction, lacking consideration, will not be binding, and the creditor may sue for any unpaid balance.

Examples:

(1) When a physician, attorney, or accountant sends a bill for \$500 for services, the claim is unliquidated unless there has been prior agreement on the bill. If the patient or client sends a check for \$350 indorsed, "In full payment," cashing the check constitutes an accord and satisfaction: subsequent efforts to collect the difference must fail.⁸²

(2) If in Example (1) the creditor, before cashing the check, strikes out the words "In full payment" or adds words of his own to qualify the debtor's language, the attempt to cancel or modify the debtor's terms will be ignored: the check will be deemed cashed on the *debtor's* terms. The result is an accord and satisfaction.

Undisputed claims; no genuine dispute. If, in Example (1) above, the claim were undisputed, cashing the check would constitute an agreement, without consideration, to accept as full payment, less than the full amount due (see section 153, "Agreement to accept part payment in full"). Cashing the check in such case would therefore not constitute an accord and satisfaction, and the creditor could sue for the difference. (See sec. 1433.)

An accord presupposes a prior dispute. In the absence of a genuine dispute, there can be no accord and satisfaction.

Examples:

(1) You leave \$1000 in cash with me for safe keeping. When you demand your money, I send you a check for \$500 indorsed, "In full of all claims." Cashing such check would not constitute an accord and satisfaction, since there was no genuine dispute.

(2) X, without agreement on compensation, asks Y to sell certain merchandise for him, which Y does. Y deducts 10% from the proceeds of the sale, and sends X the balance by check indorsed, "Less 10% commission." Cashing such check would not constitute an accord and satisfaction, since there was no genuine dispute.

Mere retention of a debtor's check will not, in some states (New York, for example) constitute an accord and satisfaction, although in other states (Illinois, for example), failure to return the check within a reasonable time spells out an accord and satisfaction. The New York rule⁸³ reflects the majority view. (See sec. 1434.)

Accord without satisfaction. An accord not followed by a satisfaction leaves the creditor free to press his original claim.⁸⁴ The same rule holds where satisfaction is only partial.

⁸² *Jenkins v. National Mut. Building & Loan Ass'n of New York*, 111 Ga. 732, 36 S.E. 945; *Hamilton v. Stewart*, 108 Ga. 472, 34 S.E. 123; *Northern Bank & Trust Co. v. Harmon*, 126 Wash. 25, 217 P. 8; *Wildstein v. Greenberg & Sons*, (Pa.) 5 Schuylkill Reg. 285.

⁸³ *In re Riley*, 266 App. Div. 160, 43 N.Y. Supp. 2d 753.

⁸⁴ In a case tried by the author in 1922 as attorney for the plaintiff, on an original claim for \$1253, the parties had arrived at an accord in the amount of

Example: Kromer, having obtained a judgment against Heim, agreed to accept a portion in cash, and for the balance, an assignment of a patent. After receiving the cash, Kromer rejected the patent assignment. Held, Kromer could enforce the judgment by execution for the unpaid balance.⁸⁵

Statutory changes. The foregoing rules on accord and satisfaction may be modified by statute. For example, the New York statute now provides that if an accord is in writing, and it is not followed by a satisfaction, the other party has the option of pressing his original claim or insisting on the accord's being carried out.

228. Account stated *v.* accord and satisfaction. An *account stated* should not be confused with an accord and satisfaction. It represents acquiescence or admission rather than compromise, simplifies proof by reason of such admission, and prevents subsequent challenge of the facts thus admitted.

"The chief point of distinction between an accord and satisfaction and an account stated is that . . . an accord without satisfaction is of no effect as discharging or extinguishing the original debt or demand, while the failure to pay the amount agreed upon as a balance of an accounting does not prevent the transaction from constituting an account stated or from having effect as such. Whether a particular transaction constituted an accord and satisfaction or an account stated has been determined by considering that the former ordinarily involves a disputed or controverted claim, while the latter is essentially an agreement upon the accuracy and correctness of the creditor's statement of the amount due him."⁸⁶

Examples:

(1) *A* sends *B* a bill, which *B* approves as correct. Later, *B* refuses to pay the bill on the ground that some of the goods mentioned in it were not up to quality. *A* may ignore *B*'s contention and sue *B* on an account stated.

(2) See section 1436.

229. Discharge by impossibility: in general. Contracts may be impossible of performance when made, or the impossibility may arise thereafter. In the former case, the question is not whether the contract is discharged but whether it comes into existence. In the latter case, the contract may under certain

\$600. Defendant paid \$300 on account of the accord but made no further payment. Plaintiff therefore sued for the amount of the original claim, less \$300 paid on account, or \$958. Judgment went for plaintiff, from which defendant appealed. Following affirmance and execution, defendant ultimately paid over \$1100 in satisfaction of judgment, interest and costs, although the claim could have been satisfied by payment of an additional \$300 on the original accord. *Pace & Pace v. Coastwise Lumber & Supply Co.*, New York City, Manhattan Municipal Court, Index No. 47980—1922.

⁸⁵ *Kromer v. Heim*, 75 N.Y. 574.

⁸⁶ 1 *Corpus Juris Secundum* 463.

conditions be discharged (or, to be strictly accurate, performance may be excused) by the fact that performance has become impossible.

230. Impossibility at time of making. If a contract, when made, is impossible of performance, and both parties know it, there can be neither intention nor expectation of performance, hence no contract. If neither party knows of the impossibility, there is also no contract, because of the mutual mistake. If one party knows it and the other not (as where a person promises payment out of a fund he knows does not exist, but which the other party believes does exist), the promisor is bound.

231. Impossibility arising after contract is made. The earlier cases held that when one undertakes a duty by contract, he undertakes the risk of performance and will therefore not be excused by impossibility, because he might have anticipated and provided against it in the contract. This rule was more rigorous than realistic. It has given way to the more modern rule that intention controls. The intention may be expressed in the contract, implied from the facts, or implied in law.⁸⁷

Intention expressed. Parties may expressly provide in the contract that impossibility arising from specified causes shall or shall not excuse performance.

Intention implied from circumstances. The circumstances may indicate, as an implied condition of the contract, that the parties acted on the assumption that certain conditions, such as life, health or subject matter, would continue to exist, or else that they embarked upon an absolute undertaking regardless of such conditions.

Continued existence of life and health: personal service contracts. Contracts for personal services are based on the assumption of continued life and well-being; hence impossibility because of death, insanity, sickness or other physical disability excuses performance of *personal service contracts*.

Continued existence of subject matter: in general. Where the circumstances show that a contract is impliedly based on the assumption—as a condition of the contract—that its subject matter will continue to exist, impossibility through destruction of the subject matter will excuse performance.⁸⁸

Preventable v. unpreventable destruction of subject matter. A distinction should be made, however, between preventable and unpreventable destruction of subject matter. If a party makes a contract obviously rest-

⁸⁷ *Lloyd v. Murphy*, (Cal. App.) 142 P. 2d 939, subs. op. 25 Cal. 2d 48, 153 P. 2d 47; *Niblett Farms v. Markley-Bankhead, Inc.*, 202 La. 982, 13 So. 2d 287.

⁸⁸ *Leonard v. Autocar Sales & Service Co.*, 392 Ill. 182, 64 N.E. 2d 447.

ing on the assumption that things will remain as they are, impossibility inherent in the nature of things and not subject to personal control will excuse performance; but impossibility which is personal, rather than objective, will not excuse performance. In the former group are cases involving destruction of subject matter or prevention of performance by fire, war, or the so-called "acts of God," such as flood, lightning, rain, hail, snow, tornado, hurricane, and so on. In the latter class are situations which depend in whole or in part on personal deficiency.

Examples of impossibility excusing performance (unpreventable):

(1) Contract to move barn: barn destroyed by lightning before it could be moved.

(2) Agreement to give series of concerts at music hall, which was destroyed by fire before the concerts could be given.

(3) Defendants, after agreeing to sell and deliver a particular consignment of cotton consisting of 621 bales, delivered only 460 bales, the other 161 bales having been destroyed by fire without defendants' fault. Plaintiff sued. Judgment for defendants. The parties, by their contract, obviously contemplated the continued existence of the cotton.⁸⁹

Examples of impossibility not excusing performance (preventable):

(1) Insolvency, financial stringency, great difficulty or inconvenience, unexpected expense, and so on.

(2) Lack of sufficient labor supply.

(3) Failure of expected source of raw materials or supply.

(4) Booth contracted with a railroad company to sell and deliver 400 tons of rails made of iron with steel caps. He then contracted with the Spuyten Duyvil Rolling Company for manufacture of the steel caps. The rolling mill was destroyed by fire, the caps could not be delivered, and Booth lost his contract with the railroad company. Booth sued the rolling mill for consequent damages, and the rolling mill pleaded impossibility as an excuse. The court rejected the excuse, saying: "There was no physical or natural impossibility, inherent in the nature of the thing to be performed, upon which a condition that the mill should continue can be predicated. The article was to be manufactured and delivered, and whether by that particular machinery or in that mill would not be deemed material."⁹⁰

Absolute undertaking: no implied conditions. If a party undertakes to do a given thing by a given time, without other qualification, he is bound regardless of subsequent impossibility affecting the subject matter of the contract, because he thereby impliedly assumes the risk of impossibility. In such cases, neither the so-called "acts of God," nor of the enemy, will excuse performance, because the promisor has impliedly assumed these risks.

Examples:

(1) A contract to manufacture and deliver 5000 sweaters within a given period, rendered impossible by a strike.

⁸⁹ *Dexter v. Norton*, 47 N.Y. 62.

⁹⁰ *Booth v. Spuyten Duyvil Rolling Mill Co.*, 60 N.Y. 487.

(2) A contract to ship 300 barrels of apples at a certain time, rendered impossible because the harbor froze over.

Impossibility because third party disappoints. If a party makes a contract which cannot be performed without the consent or co-operation of a third party, he is not excused because of inability to secure such consent or co-operation.

Example: Dunbar Molasses Co. as seller contracted to sell to Canadian Industrial Alcohol Co., Ltd., as buyer, 1,500,000 gallons of molasses "of the usual run from the National Sugar Refinery." Deliveries were to begin three months after date of seller's contract with the refinery. Shortly after deliveries began, the refinery, for economic reasons, curtailed its output, so that the seller was unable to fulfill its contract with the buyer. There was no failure of sugar crop, no fire or strike at the refinery. Buyer sued seller. Held, the fact that the refinery disappointed the seller is no reason why the buyer must suffer.⁹¹

Intention implied in law: doctrine of "frustration." In recent years, the courts have liberalized the rule that intention governs the question of whether impossibility excuses performance or not. Where "the true intent of the parties was thwarted by the happening of subsequent events over which they had no control and which were unforeseen at the time," said the Court recently,⁹² equitable relief will be applied and performance excused. "The doctrine of frustration," said the Court, "is one born of compelling necessity, rooted in truth, and stems from actuality." The doctrine has been held, however, not to relieve a tenant from paying rent because of temporary government use of premises for war purposes.

232. Impossibility created by party himself. If a person is unable to perform because of impossibility created by himself, he cannot plead such impossibility as an excuse for nonperformance; as when a person agrees to sell a horse and then shoots the horse, or agrees not to leave his employment without giving two weeks' notice and then commits a crime for which he is sentenced to jail and is consequently unable to give the required two weeks' notice.

233. Impossibility created by law. Where performance of a contract becomes illegal, it will be excused.⁹³

Example: A, by lease of a wooden structure to B, agrees to rebuild it promptly in case of destruction by fire. If the structure is destroyed by fire, but in the meantime a municipal ordinance has prohibited wooden

⁹¹ *Canadian Ind. Alcohol Co. v. Dunbar Molasses Co.*, 258 N.Y. 197.

⁹² *Farlow Realty Corporation v. Woodsam Associates*, 49 N.Y. Supp. 2d 367, 371-2.

⁹³ *Hood v. Southern Production Co.*, 206 La. 642, 19 So. 2d 336; *Fast Bearing Co. v. Precision Development Co.*, (Md.) 44 A. 2d 735; *Cinquegrano v. T. A. Clarke Motors*, 69 R.I. 28, 30 A. 2d 859; *Takahashi v. Pepper Tank. & Contracting Co.*, 58 Wyo. 330, 131 P. 2d 339.

structures in the zone where the building was located, performance of the agreement to rebuild is excused.

234. Discharge by operation of law. A contract may be discharged by operation of law in any of the following ways:

- (a) By impossibility (secs. 229-231).
- (b) By merger (sec. 225).
- (c) By the statute of limitations (sec. 96).
- (d) By discharge in bankruptcy (sec. 1343).

Insolvency v. bankruptcy. Insolvency is a financial status, bankruptcy a legal one. (See sec. 1281.) Insolvency alone furnishes no legal ground for discharge. A discharge in bankruptcy, however, discharges the bankrupt from all his contract obligations, with certain exceptions noted in the chapter on bankruptcy (sec. 1345).

Assignment for benefit of creditors. Under state debtor and creditor laws, an insolvent may transfer all his assets to an assignee for the benefit of his creditors. This, however, does not discharge the assignor of his debts, except to the extent that the debts are paid, or the creditors consent to a discharge. At one time, under the statutes of some of the states, an assignor could obtain a court order discharging him of all his debts if he complied with the statute. These statutes have either been repealed or suspended by the National Bankruptcy Act. (See sec. 1282.)

235. Discharge by alteration of instrument. If one party to a written instrument alters it without the other's consent, the other party may, if he wishes, declare the contract discharged.⁹⁴ The alteration, however, must be *intentional* and *material*. An alteration is material if it changes the legal effect of a contract; otherwise not.

When a party intentionally makes an alteration which he *thinks* is material, but which really has no legal effect, the rule is not uniform. Some states permit the other party to void the contract if he so wishes, but the better rule is that "if the change is immaterial, the motive, even though fraudulent, will be immaterial."⁹⁵

236. Discharge by breach. If you and I make a contract, and I breach it, you are thereby discharged; that is, you are under no obligation to proceed further with the contract.

Example: If prepayment is required under a contract of sale as a condition for delivery, the seller is discharged by failure to make such prepayment.

237. What constitutes breach. A contract is commonly breached by (a) failure to perform it. It may also be breached

⁹⁴ *Lowe v. Henson*, (Tex. Civ. App.) 190 S.W. 2d 423.

⁹⁵ 3 *Corpus Juris Secundum* 926.

by (b) making performance impossible (sec. 232) and by (c) renunciation or "anticipatory breach."

Anticipatory breach. If a party to a contract *unqualifiedly* announces in advance of performance date that he will not perform, he commits an anticipatory breach, and the other party need not wait for the performance date but may sue at once.

Examples:

(1) A, having contracted on February 1st to sell 100 bbls. flour for delivery on July 1st, notifies B on March 1st that he will not deliver. B may sue at once.

(2) If, in (1), A is adjudicated a bankrupt on March 1st, he thereby commits an anticipatory breach, as if he had announced on that date that he would not perform. B may file his claim without waiting for the performance date.

238. Remedies for breach. Remedies for breach of contract include: discharge, damages, *quantum meruit*, and specific performance. For discharge resulting from breach, see section 236.

239. Damages. Damage is recompense for a wrong. In a breach of contract, it represents the loss *directly and naturally* resulting from the breach. It therefore excludes speculative, remote or possible losses which cannot be shown to have directly resulted from the breach. Damages may be *general*, *special* and *liquidated* (sec. 1439). Liquidated damages are frequently resorted to in building contracts; but if the damages thus agreed upon in advance in case of breach are really in the nature of a penalty, they will not be enforced. When a wrong is established but no real damage shown, a jury may award *nominal* damages (sometimes fixed at six cents).

Measure of damage: in general. As a rule, the measure of damage for breach of contract is the loss which the injured party can *prove* he sustained because of the breach. In a contract of sale the measure of damage is the difference between the contract price and the market price at the time of the breach.

Measure of damage: breach of employment contracts. The measure of damage for breach of a contract of employment is the sum or sums which the employee would have been paid had the contract not been breached, less what the employee has earned or should have earned for the balance of the contract period.

Measure of damage: contracts for lifetime employment. For breach of a lifetime contract, the employee may consider the full lifetime period in basing his damage for the breach, and may bring a single suit to recover full damages immediately upon his discharge. For the rules which should

govern a jury in fixing damages for the breach of a lifetime contract, see section 1440.

240. Mitigating damages. The law requires an injured party to *mitigate*, not *aggravate* his damage; that is, to keep damages down as far as possible.

Examples:

(1) Wood contracts with Long, a shirtmaker, for 1000 men's shirts. Long manufactures and delivers 500 shirts. Wood pays for them and at the same time asks Long not to manufacture any more shirts, because he cannot dispose of more. If Long sues Wood for the breach, he may include, as damage, the profit he would have made on the additional shirts, plus any extra expense he has already been put to because of Wood's order, such as the cost, less salvage, of the material needed to make up the extra 500 shirts, and so on; but Long must not aggravate the damage by proceeding to manufacture the additional shirts and by charging the cost thereof as additional damage.

(2) If I hire you for a year and discharge you at the end of six months, you must mitigate the damage by trying to find another position (though not a different type of position, nor a position in a different locality).

241. *Quantum meruit*. The term *quantum meruit* means "as much as he deserves." If you hire me for a year by an express contract and discharge me without pay at the end of the month, I need not sue on the express contract, but may sue you on the *implied contract* that where one accepts services or benefits from another, he will compensate the latter by an amount representing the *reasonable value* of the services or benefits received. (See sec. 194, second example.)

242. Specific performance. Where damages at (common) law would be inadequate, either because there is no yardstick to measure the loss, or because a party, to receive full justice, is entitled to acquire *the thing contracted for*, a court of equity will decree the *specific performance* of the contract. Contracts of this nature usually involve *land* and *unique chattels* not readily obtainable on the open market, such as antiques, heirlooms, famous paintings, manuscripts and first editions of books, ancient coins and relics, patents, copyrights, or shares of stock (sec. 1442) in a closely held corporation.

243. Injunction in lieu of specific performance. In contracts involving personal services, wherein a court of equity is unable to decree specific performance, the remedy of injunction may accomplish the same end. For example, a court of equity cannot compel an actor to play or a singer to sing; but it can de-

cree that they shall not play or sing for *someone else* until they specifically perform their contracts. Injunctions will not be granted to restrain employees who breach their contracts from taking employment elsewhere, unless their services are *unique and extraordinary*; for in the ordinary case, damages for the breach should suffice.

An injunction is a writ or order issued by a court, commanding an act which the court regards as essential to justice, or restraining an act which it deems contrary to equity and good conscience. In the former case the injunction is *mandatory*, in the latter, *preventive* or *prohibitory*.

F. Arbitration and Award

244. Arbitration defined. Arbitration is a procedure for settling disputes out of court. The object is to save parties the expense of litigation, and the public the expense of a trial. Public policy therefore favors arbitration.

245. Types of arbitration. Arbitration may be *international* (governing disputes between sovereign bodies), *industrial* (governing labor disputes), and *commercial* (governing commerce and trade). It is the last type which is considered here.

Commercial arbitrations may be classed as *common law* and *statutory*. Originally, arbitration proceedings were governed solely by the common law (court decisions). Today, the large majority of our states have adopted arbitration statutes.⁹⁶ These vary in many details, but they follow certain basic principles. It would be impracticable to set forth here the numerous statutory variations. Reference will be had, in large part, to the New York statute as typical.

246. Arbitration distinguished from reference. An arbitration is distinguishable from a reference in three respects:

(1) *Source of authority*: Arbitrators are selected by the parties themselves; a referee is designated by the court.

(2) *Finality of decision*: The decision of arbitrators in the form of an award is final, and if there has been no corruption or partiality, and so on, the court has no right to vacate, modify or correct the award, nor to use discretion in the facts found by the arbitrators. In the case of a reference (unless a referee is appointed to hear and *determine*), the court may refuse to confirm the referee's findings.

⁹⁶ Congress too has adopted various acts providing for arbitration; for example, the Arbitration Act of 1925 applicable to commercial and maritime transactions and the arbitration provisions of the Bankruptcy Act.

(3) *Procedure*: The procedure, time and place for hearings, and so on, may be provided for by the parties themselves in the written submission. The proceedings are informal, and strict rules of evidence are usually dispensed with. A reference is usually governed by the rules of evidence applicable to the regular conduct of a trial.

247. Matters which cannot be arbitrated. By common law, statute, or both, matters involving the following cannot be decided by arbitration: (a) a controversy respecting real property interests amounting to a fee or a life estate (sec. 1027), (b) claims arising out of illegal contracts or transactions, and (c) criminal liability.

248. Basis for arbitration: contract *v.* compulsion. Arbitration is a voluntary proceeding, resting on mutual assent. There is no such thing as compulsory arbitration, except where the parties have already agreed to arbitrate. Arbitration may be provided for by:

(a) Agreements to arbitrate a controversy which may arise thereafter, as by a provision in a contract to settle any dispute thereunder by arbitration; or

(b) *Submissions*, by which parties agree to submit an *existing* controversy to arbitration.

In either of the events just mentioned, arbitration becomes enforceable and the parties must go through with it.

249. Requisites of arbitration agreement. Every arbitration agreement, whether in the form of an agreement to arbitrate or a submission, must be evidenced by a writing, signed by the parties or their lawful agents. All contract requisites must be clearly present.

Example: To establish an enforceable contract to arbitrate, it is not sufficient to show merely that a seller stamped his invoices, "All controversies arising from the sale of these goods are to be settled by arbitration," and that the only proof of mutual assent was that the buyer used voucher checks to pay such invoices. (See sec. 1449.)

250. Provisions for appraisal, and so on *v.* agreements to arbitrate. An arbitration proceeding must put an end to the dispute. A clause referring some matter for appraisal, calculation or valuation is not enforceable as an arbitration agreement.

Example: In a case involving the manufacture of playing cards, the contract provided for royalties to be determined by certified public accountants, one to be selected by each of the parties, and the two thus selected

to designate a third. The court held that this was not an enforceable contract to arbitrate.⁹⁷

251. Who may arbitrate. Any person or corporation having the capacity or power to contract may submit disputes to arbitration. This excludes infants and persons incompetent by reason of insanity, idiocy or habitual drunkenness (except upon prior court appointment of a guardian or committee to act for them).

Partnerships may submit disputes to arbitration, but such proceedings are not binding on the firm except on concurrence of all partners (sec. 684).

252. Irrevocability of arbitration agreements and submissions. In states where arbitration is governed by statute, arbitration agreements and submissions are generally irrevocable except by mutual consent or by operation of law (as in the case of death, insanity or destruction of the subject matter of the arbitration).

In Illinois, for example, the statute provides that submissions are irrevocable unless a contrary intention is expressed.

In New York, the statute provides that arbitration agreements and submissions "shall be valid, enforceable and irrevocable, save upon such grounds as exist at law and in equity for the revocation of any contract" (such as fraud, duress, and so on). Upon death or incompetency of a party after entering into an arbitration agreement or submission, the proceedings may be instituted or continued upon application of, or notice to, the executor or administrator of the decedent or the committee of the incompetent.

Refusal to proceed. If one of the parties neglects or refuses to proceed with the arbitration, the other may apply for a court order compelling the party in default to proceed. The only valid ground on which a party can oppose such application is that no valid contract or submission was entered into.

Attempts to substitute court action for arbitration proceedings will be stayed by the court, upon proof that the issue sought to be litigated is the subject of an existing arbitration agreement or submission.

253. Arbitrators. The agreement or submission may provide for an arbitrator agreeable to both sides, or it may provide that each is to select an arbitrator, the two to select a

⁹⁷ *In re Culbertson*, 259 App. Div. 263, 18 N.Y. Supp. (2d) 815.

third, or umpire. In the latter event, the designation must be in writing.

Failure to name arbitrator or umpire. In case of failure to select an arbitrator or umpire, or to provide a method for selecting one, or to fill a vacancy, the court will designate one on application of either party.

Who may serve as arbitrator: attorneys and accountants. Practically any person is competent to act as an arbitrator, provided he is fair, disinterested and impartial.⁹⁸ An attorney at law or an accountant employed by a party is not, strictly speaking, disinterested or impartial; yet because of special familiarity with the matter in dispute he is frequently selected as an arbitrator. When both sides are fully aware of the facts but proceed with the arbitration notwithstanding, they cannot later refuse to abide by the decision because of the special interest of such attorney or accountant, especially when both sides have been similarly represented, where the relationship was not suppressed, where no timely objection was made, nor misconduct shown, and where a third arbitrator or umpire was selected by the other two. The practice, however, of selecting champions as arbitrators has been condemned.⁹⁹

Power of arbitrators: The arbitrators or a majority of them may require any person to attend before them as a witness; and they have and each of them has the same powers with respect to all the proceedings before them as are conferred upon a board or a member of the board authorized by law to hear testimony. All the arbitrators must meet together and hear all allegations and proofs of the parties; but an award by a majority of them is valid unless the concurrence of all is expressly required in the submission.

254. Arbitration proceedings. The arbitrators must first be sworn by an officer authorized by law to administer an oath,

⁹⁸ *Scott v. Arden Farms Co.*, (Del.) 28 A. 2d 81, 86; *Johnson v. Korn*, (Tex. Civ. App.) 117 S.W. 2d 514.

⁹⁹ " . . . the practice of arbitrators of conducting themselves as champions of their nominators is to be condemned as contrary to the purpose of arbitrations, and as calculated to bring the system of enforced arbitrations into disrepute. An arbitrator acts in a quasi-judicial capacity, and should possess the judicial qualifications of fairness to both parties, so that he may render a faithful, honest, and disinterested opinion. He is not an advocate whose function is to convince the umpire or third arbitrator. He should keep his own counsel, and not run to his nominator for advice when he sees that he may be in the minority. When once he enters into an arbitration he ceases to act as the agent of the party who appoints him. He must lay aside all bias, and approach the case with a mind open to conviction and without regard to his previously formed opinions as to the merits of the party or the cause. He should sedulously refrain from any conduct which might justify even the inference that either party is the special recipient of his solicitude or favor. The oath of the arbitrators is the rule and guide of their conduct."—Opinion of Judge Pound in *American Eagle Fire Insurance Co. v. New Jersey Insurance Co.*, 240 N.Y. 398, 405.

faithfully and fairly to hear and examine the matters in controversy and to make a just award to the best of their understanding, unless the oath is waived by the written consent of the parties to the submission or their attorneys. The arbitrators then appoint a time and place for the hearing, cause notice thereof to be given to each of the parties, and may adjourn the hearing from time to time, but not beyond the day fixed in the submission for rendering the award. The procedure and circumstances under which hearings are held may be prescribed and limited by the terms of the written submission, in which event, the arbitrators must abide by such terms in proceeding with their hearings. Otherwise, the arbitrators may adopt their own procedure, which may be informal.

255. The award. The determination or decision of the arbitrators is known as the *award*. To be enforced, the award must be in writing and signed by the arbitrators making it; must be made within the time limit, if any, fixed in the contract or submission; must be acknowledged or proved and certified in like manner as a deed to be recorded (sec. 1050); and must be either filed with the clerk of the court or delivered to one of the parties. Upon application of either party, the award must be confirmed by the court, unless it is vacated, modified or corrected.

Grounds for vacating award. The award must be vacated by the court in any of the following situations:

- (1) Where it was procured by corruption, fraud or other undue means.
- (2) Where there was evident partiality or corruption in any of the arbitrators.
- (3) Where the arbitrators were guilty of misconduct in refusing to postpone the hearing upon sufficient cause shown, or in refusing to hear evidence pertinent and material to the controversy, or were guilty of any other misbehavior which might have prejudiced the rights of any party.
- (4) Where the arbitrators exceeded their powers, or so imperfectly executed them, that a mutual, final and definite award upon the subject matter submitted was not made.
- (5) Where there was no valid contract or submission.

Where the award is vacated, the court may direct a rehearing before the same or new arbitrators.

Modification or correction of award. The court may modify or correct the award in any of the following situations:

- (1) Where there was an evident miscalculation of figures or an evident mistake in the description of any person, thing or property referred to in the award.

(2) Where the arbitrators have awarded upon a matter not submitted to them, nor affecting the merits of the decision upon the matters submitted.

(3) Where the award is imperfect in a matter of form not affecting the merits of the controversy and where, if it had been a referee's report, the defect could have been amended or disregarded by the court.

256. Judgment on the award. Upon the granting of an order confirming, modifying or correcting an award, judgment may be entered accordingly with the same force and effect as if the dispute had been tried in court.

Questions and Problems for Review

1. Give the essential elements of a contract, and define or explain each element. *AI Nov. 1928 (1)*

2. Prepare a simple contract with the essential elements arranged in separate paragraphs. Point out the essential elements. *AI May 1927 (1)*

3. A retail storekeeper contracted with a newspaper to publish an advertisement in which certain articles were listed at the price of \$15 each. The newspaper negligently and erroneously printed the price of these articles as \$5 each. The newspaper sued the storekeeper for the contract price of the advertisement. The storekeeper set up a counterclaim that he was obliged by law to sell the articles at \$5 instead of at \$15 and that he thereby incurred a heavy loss. Was his counterclaim a valid defense? *AI Nov. 1933 (5)*

4. *C* published an offer of a reward for information leading to the discovery of the murderer of his brother. The reward was payable on conviction of the criminal. *M*, without knowledge of the reward offered and being in fear of death, gave the desired information. *M*, on regaining his health, sues to recover the reward. Will he succeed? Explain. *NY Nov. 1926 (13)*

5. *A* entered into the following agreement with the R. S. Cement company:

"Memorandum of agreement made this 6th day of July, 1905, between *A*, first party, and R. S. Cement company, second party, to wit., first party agrees to give the 'R. S.' brand cement the preference in his sales of cement for the year 1905, and in consideration thereof, second party agrees to sell said brand of cement to the first party during the year 1905 at the price of 95 cents a bbl. f.o.b. Haverstraw, New York."

A ordered several shipments of cement which were duly delivered and paid for. Subsequently the market price for cement rose and the cement company notified *A* that it would furnish no more cement under the agreement. *A* then purchased his cement elsewhere during the remainder of the year at higher market prices, and he sought to recover from the cement company as damages the difference between the cost of the cement purchased by him at the prevailing

market price and what the cement would have cost at the price provided in the agreement. Could he recover? *AI Nov. 1920 (5)*

6. When can an offer to perform a contract be withdrawn? *AI Nov. 1918 (Contr 3)*

7. On May 1, 1927, Shearman signed and sealed a formal written offer to sell to Allen at any time on or before May 15, 1927, certain merchandise at a specified price. On May 5, 1927, Shearman wrote Allen that the offer was canceled and withdrawn. Upon receipt of that letter on May 6, 1927, Allen formally accepted the offer and thereafter sued to enforce the contract. What decision would you render in the action? *AI May 1927 (3)*

8. *A* in writing offers to sell to *B* three dozen hats. The description of the hats, the price of them and the terms of the proposed sale are all set forth in the offer and are all sufficiently definite for a contract. *A* also states in the offer as follows:

"I agree that this offer will remain open for two weeks and that I cannot revoke it until the expiration of that time."

At the end of one week *A* writes *B* that he revokes the offer. In reply *B* writes to *A* that he accepts the offer to sell as stated in *A*'s original letter. This letter is received by *A* before the expiration of the two weeks. Is there a contract? *AI May 1928 (7)*

9. *A* sent an order by mail to *B* for 100 barrels of flour at \$15 a barrel on twenty days' credit. *B* replied, saying, "I accept your order and will ship the goods, but on ten days' credit." *A* received this letter and made no reply. After *A*'s receipt of the letter, *B* wrote again, saying: "I have reconsidered the matter and will allow twenty days' credit. Am shipping the goods." *A* refused to receive or pay for the goods. Is *A* liable? *AI May 1920 (4)*

10. *X* wrote to *Y* offering to sell *Y* 2000 three-inch boiler tubes for \$2.25 each. *Y* replied, "I will buy 1200 tubes at your price." *Y* claimed that a contract was made and that *X* was bound to deliver the 1200 tubes. Was he? *AI May 1924 (5)*

11. *A* wired an offer to sell oil to *B*. The telegram was sent at 9 A.M. and received by *B* in due course at 11.15 A.M. *B* wired his acceptance at 12.45 P.M., and it reached *A* in due course at 4.15 P.M. At 2 P.M. of the same day, *A* had wired a revocation of his offer, which reached *B* at 3 P.M. When, if at all, was a contract completed in this case? *NY June 1932 (14)*

12. *A*, in New York, wrote *B* in Buffalo, offering certain goods for sale at a certain price. *B* wrote a letter to *A* accepting the offer and posted it in Buffalo. Before *A* received the letter he received a telegram from *B* stating that he withdrew the acceptance. Was a valid contract made? Explain the principles involved. *AI Nov. 1919 (6)*

13. On January 31, 1921, Travis & Wood, commission merchants at Buffalo, N.Y., wrote a letter to Vassar & Camp at New York,

offering to sell 500 gallons of linseed oil at a certain price per gallon. The letter was received by Vassar & Camp on February 2, 1921, and on the same day they mailed a reply to Travis & Wood, accepting the offer and giving directions as to shipment. On February 3, before the receipt of the acceptance, Travis & Wood telegraphed, revoking the offer. Was the revocation effectual to prevent the consummation of the agreement? *AI May 1921 (6)*

14. August 1, 1927, *A* in Baltimore by letter to *B* in New York offers to sell to *B* 500 bushels of potatoes. The price, description, terms, and place of delivery are all set forth in the letter and are sufficiently definite for a contract. On August 2, 1927, the price of potatoes rises, and *A* wires *B* that he revokes his offer of August 1, 1927. A few minutes before receiving this wire *B* had put in the mail a letter to *A* properly addressed and stamped in which he accepted *A*'s offer. *A* does not receive this letter from *B* until after *B* has received *A*'s wire. Was there a contract between *A* and *B*? *AI May 1928 (5)*

15. At 11:30 A.M. Shaw wired Brauer, "Subject prompt reply will engage you to make audit \$2200 fee." Brauer received this wire at 12:16 P.M. At 12:28 P.M. Brauer wired Shaw accepting the offer. At 1 P.M. Shaw had not received Brauer's wire and Shaw wired Brauer revoking his offer. At 1:43 P.M. Shaw received Brauer's wire accepting the offer. Was there a contract? *AI Nov. 1930 (8)*

16. A document entitled "Articles of Agreement," duly executed, stated that the parties to it agreed to execute a formal lease of certain specified real estate for a specified term of years at a specified rental. The document provided for "the usual and proper covenants" as to possession, surrender and delivery, warranty, re-entry and the like and recited that the lease was to contain "in brief, all of the usual and formal clauses to the mutual satisfaction of the parties." Did the phrase "to the mutual satisfaction of the parties" make the document indefinite, a mere agreement to agree, and thus unenforceable as a contract? *AI Nov. 1933 (8)*

17. What are the elements of legal fraud? What effect has fraud on a contract? *NY Nov. 1931 (8)*

18. Defendant was the owner of a half interest in, and was director, vice-president and general manager of, a mutual casualty company, a corporation engaged in insuring owners of taxicabs against damages for personal injuries. As an inducement to plaintiff to purchase defendant's interest in said corporation, defendant gave plaintiff a written statement of the corporation's financial condition which showed a surplus of \$112,201.34. In reliance upon said statement, plaintiff purchased defendant's interest, and shortly thereafter an examination by the state insurance department showed a deficit of \$47,943.01 as of the date of the statement. The difference lay in the reserve for outstanding losses. The correct amount

of that reserve could be determined only by examining some 6000 pending suits and claims and placing on each a reasonable estimate of liability. No evidence was offered by defendant to show how he had determined the amount of the reserve as shown in his statement. On these facts, should defendant's statement be held fraudulent? *AI Nov. 1933 (7)*

19. *X* owned a stationery business which for a number of years had earned a net profit of \$3000. By falsely stating that the net profit had been \$10,000, *X* sold the business to *Y*, who would not have bought it if the truth had been disclosed by *X*. In an action by *Y* for rescission, *X* defended on the ground that *Y* had made inquiries of other persons and that if *Y* had been more diligent *Y* could have discovered the truth. For whom should judgment be given? *AI May 1931 (3)*

20. *B*, a violin expert, ascertained that *A* owned an old violin of famous make, worth many thousands of dollars. In talking with *A*, *B* found that the violin had been in *A*'s family for many years but that *A* had no knowledge of its true value. *B*, after some persuasion and by offering what to *A* seemed an excessive price (\$350), succeeded in buying the instrument. Later *A* heard of the true facts and, tendering a return of the purchase price, sued to recover the violin. What, in your opinion, would be the result? *AI May 1929 (8)*

21. Plaintiff owned 60% of the capital stock of the Monitor Baking Corporation in the city of *X*. Defendant, who was president and manager of that corporation, owned 10% of its capital stock. Defendant told plaintiff that he intended to start a baking company of his own in a city over 500 miles away. Plaintiff thereupon contracted to buy defendant's stock in the Monitor Baking Corporation, making a cash payment on account and giving a note for the balance. Immediately thereafter, defendant organized and became president of a new baking corporation in the city of *X* which was to compete directly with the Monitor company. Before maturity of the note and prior to the transfer of the stock, plaintiff sued in equity for rescission of the contract. Is plaintiff entitled to rescission? *AI Nov. 1933 (11)*

22. (a) In contract law, distinguish between a warranty and a representation.

(b) What effect has a breach of warranty or false representation on the contract? *NY Apr. 1934 (1)*

23. (a) Define mistake and give its effect on contracts.

(b) Define misrepresentation and state its effect. *AI Nov. 1918 (Contr 5)*

24. Norton, owner of a pulp mill in Maine, negotiated with Burns for the sale of the mill. Burns lived in New York City, where Norton arranged to meet him. Norton left Maine on October 2nd, met Burns in New York, and on October 5th they executed the con-

tract of sale. On October 4th the mill was destroyed by fire, a fact unknown to both parties when the contract was signed. What are the rights of the parties? *AI Nov. 1926 (1)*

25. Wickham, a New York businessman, had title to a large timber tract in the Northwest which he honestly believed contained approximately 5,000,000 feet of lumber, such belief being based on reports of competent timber experts. Wickham contracted to sell the tract to Monroe, both believing the reports in Wickham's possession to be correct. Actually, unknown to either party, the tract had been stripped of good timber between the time of Wickham's survey and the time of sale. What was Wickham's position? *AI May 1924 (6)*

26. Brown is in the lumber business. Smith is a building contractor and, being about to erect a building, left at the office of Brown a list containing various items of lumber needed. In the price submitted by Brown a mistake in addition of \$400 was made by Brown's bookkeeper. Smith accepted the bid. Before Smith had done anything further Brown notified Smith of this mistake and refused to perform the contract. Smith sues Brown. Who will succeed? Why? *NY Nov. 1926 (15)*

27. X lawfully came into possession of an oil painting which he sold to Y for \$75. Afterwards, X found that the painting was a valuable one, worth at least \$1200. He tried to collect \$1125 from Y. Could he? Discuss the principle involved. *AI May 1924 (7)*

28. When may a creditor enforce a contract with a minor? *AI Nov. 1917 (8)*

29. In September, 1928, Stone was twenty years and six months old. He opened a margin account with stockbroker X and did a certain amount of trading. One month later he transferred to X a similar account which he had with broker Y and caused to be delivered to X 400 shares of the then market value of \$17,450. X paid Stone's debit balance of \$13,907.91 to broker Y and thus left Stone an equity of \$3542.09 in these 400 shares. Two months later Stone closed his account with X, receiving from X \$70.99 in full payment of his credit balance. Six weeks thereafter Stone rescinded his agreement with X, disaffirmed all his transactions with X, and sued X to recover the amount of his equity in the 400 shares (\$3542.09) minus the \$70.19 paid to him by X upon the closing of his account. Stone in June, 1928, had deposited \$4000 cash as a margin with broker Y. At the time of Stone's disaffirmance of his agreement with X, the 400 shares transferred from Y had a market value of \$14,227. How much, if any amount, can Stone recover from X? *AI Nov. 1932 (10)*

30. C Glue Factory wrote S Mfg. Co. as follows: "We are instructed by our Mr. I to enter your contract for your requirements of special BB Glue for the year 1927, price to be nine cents per lb., terms 2% 20th to 30th of month following purchase. Deliveries to

be made to you as per your orders during the year and quality same as heretofore. Glue to be packed in 500 lb. or 350 lb. barrels and 100 lb. kegs and your special label to be carefully pasted thereon. *C Glue Factory*, by *D Sales Manager*." At the bottom of the letter *S* wrote the words "Accepted *S Mfg. Co.* by *S pres.*" and returned it to *D*. Between January 1927 and September 1927, *S Mfg. Co.* received and paid for 43,700 pounds of glue. In October 1927, *S Mfg. Co.* ordered 126,100 lb. and in November 1927, 79,891 lb., which it needed to meet its requirements, and *C Glue Factory* made no deliveries. *S Mfg. Co.* had in anticipation of performance of contract sold 42,000 pounds of this glue. As it was unable to purchase any in the open market, it lost its profit of \$6431.28, for which sum it sues *C Glue Factory*. Can *S Mfg. Co.* recover? Give reasons. *NY Nov. 1928 (13)*

31. Wolff was the selling agent for Knox Mills, Inc., and since 1924 had owned 100 shares of its common stock. Claghorn was president of the corporation. Wolff and Claghorn executed a contract under seal whereby Claghorn agreed to purchase Wolff's stock at par value at any time upon Wolff's request. Wolff gave Claghorn the right to purchase it if Wolff's contract with the corporation should terminate or at any time within thirty days after Wolff's death. The stock certificate was endorsed as follows: "This certificate is subject as to transfer to a certain agreement made between Jacques Wolff and Edwin B. Claghorn, dated November 15, 1926." This contract was made binding upon and to enure to the benefit of the executors, administrators and assigns of each party "provided that no assignment of this agreement shall be made by said Wolff without the written consent of said Claghorn." On November 3, 1930, Wolff duly requested Claghorn to purchase this stock and tendered it to him. Claghorn refused to purchase it on the ground that the contract was void for lack of mutuality and of consideration. Is this contract valid? *AI Nov. 1932 (1)*

32. Define consideration in the law of contracts and distinguish between a good and a valuable consideration. *AI Nov. 1918 (Contr 2)*

33. Curtis, a public accountant, was engaged by Black to make an audit of Black's books, at specified *per-diem* rates. During the course of this audit, Curtis uncovered a defalcation whereby Black saved \$25,000. After the audit was concluded and Curtis had rendered his report, Black promised to pay Curtis an additional fee of \$5000 for uncovering the defalcation. Can Curtis hold Black to this promise? *AI Nov. 1930 (6)*

34. State in each of the following cases whether or not Culver is legally bound by his promise, and state the principles of law on which your answer is based:

(a) Hawkins, upon reaching the age of sixty-five years, retired from the employ of Culver, and immediately thereafter Culver

promised to pay Hawkins \$100 each month as long as Hawkins lived. Culver had no established pension plan and at no time prior to his retirement had Hawkins expected or had any reason to expect a pension.

Culver made the payments for four years but then discontinued them although Hawkins was still alive.

(b) Culver signed a subscription list by which he promised to give \$100 to the Central Church toward the cost of a new organ. Other subscribers signed before and after him. The Central Church purchased the organ but Culver refused to pay the \$100. *AI May 1933 (1)*

35. A made a written contract with B to purchase B's drygoods store, A paying B \$2000 at the time when possession was given and agreeing to pay the balance of \$2500 on or before January 1, 1923. On January 3, 1923, the balance due being unpaid, A secured B's agreement to postpone the payment until April 1, 1923. On March 5, 1923, B sued A for the balance due. Could he recover? *AI May 1923 (7)*

36. Jones is indebted to Walker for \$1000. When the debt matures, Jones agrees to pay interest at five per cent if Walker will extend the time of payment for three months. Can Walker collect before the expiration of the extension? If so, why? If not, why not? State the legal principle involved. *NY June 1921 (9)*

37. Can a man who pays \$400.00 offered and accepted in discharge of a debt of \$500.00 be held liable to pay the balance? *AI Nov. 1925 (I-7)*

38. An examination of the accounts of Peter Winter, who had previously become financially embarrassed, disclosed the fact that in settling with his creditors he gave notes. The record also shows that these notes were subsequently redeemed, or liquidated upon payment of sums less than the face value of the notes. Notwithstanding such facts, the notes were surrendered by the creditors for cancellation and were in the possession of Peter Winter at the time of the examination. The purpose of your examination is to prepare the opening entries for a new set of books for Peter Winter, who intends to continue in business. Is Peter Winter still liable for the balance between the face value of these notes and the amount paid by him to the holder thereof (a) if such notes were paid at maturity, (b) if the notes were paid prior to maturity? Give reasons. *NY June 1922 (10)*

39. (a) Can a large contract be bound by a small consideration?

(b) Name four things that will constitute valuable consideration. *NY May 1931 (6)*

40. A held the note of B for \$300 due August 15, 1928. On July 5, 1928, A accepted from B \$275 in full payment of B's note. Subsequently in August A sought to collect a balance of \$25 from B. Would he succeed? *AI Nov. 1928 (13)*

41. *A* entered into a contract to erect a house for *B* at a cost of \$10,000. During construction, *A* notified *B* that the price of a certain material called for by the specifications had advanced so that it could not be used unless *B* would agree to pay \$600 more. *B* agreed, but when the house was completed, refused to pay the extra \$600; so *A* brought suit. Did *B* have a defense? *AI May 1925 (6)*

42. Geller owed Gordon \$650, which was past due. After some negotiation between the parties as to payment Geller offered \$150 and an automobile worth approximately \$400 in full satisfaction of the debt. Gordon accepted. Was the debt discharged? *AI Nov. 1925 (II-6)*

43. Is a compromise with creditors a sufficient consideration for a contract? *AI Nov. 1925 (I-1)*

44. Your client entered into an agreement with all his creditors that each would take a percentage of his claim in full settlement. Two weeks after the settlement had been made, one of the former creditors brought suit against your client for the unpaid balance. Would the complainant succeed? Explain your answer. *NY May 1931 (4)*

45. Kenyon was a businessman in the city of *X*. He signed a subscription list by which he agreed to contribute \$1000 towards the purchase of a building for the local chamber of commerce. Other subscribers for the same amount signed this list both before and after Kenyon signed it, and Kenyon knew of these other subscriptions. The building was purchased in accordance with, and in reliance upon, this subscription list. Could Kenyon be compelled to pay the amount of his subscription? *AI Nov. 1934 (6)*

46. In a state where gambling is and always was unlawful, Olsen owes Marks a gambling debt and Marks engages Shepard to collect it on a 25% fee. Shepard collects the amount of the debt but refuses to transmit any part of it to Marks. Can Marks recover in an action against Shepard? *AI Nov. 1934 (10)*

47.

New York, July 15, 1929.

For value received, the bearer may call on the undersigned for one hundred (100) shares of the capital stock in the Western Union Telegraph Company, at 200, any time in thirty (30) days from date.

Or the bearer may, at his option, deliver the same to the undersigned at 200, any time within the period named, one day's notice required.

All dividends declared during the time are to go with the stock in either case, and this instrument is to be surrendered on the stock's being either called or delivered.

JOHN JONES.

(a) Give legal reasons for approving or disapproving the above instrument.

(b) If it should be shown that neither party intended to deliver or accept the shares, but merely to pay the differences according to

the rise or fall of the market, what would be the status of the instrument? *NY Nov. 1931 (15)*

48. Jones acted as a broker in the sale of Smith's home, and Smith agreed to pay him a commission of five per cent. The State of New York requires all real estate brokers to be licensed and to pay a license fee. Jones had no such license. Smith refused to pay Jones his commission, and Jones sued. Could he recover? *AI May 1923 (5)*

49. In what way or ways, if any, are the professions under disabilities with reference to contracts for services? *NY Oct. 1933 (1)*

50. Jones and Chambers were both road-building contractors. Bids were called for by the State of New Jersey for the building of a certain state road in that state. Jones proposed to Chambers that Chambers refrain from bidding in consideration of Jones' refraining from bidding against Chambers on another road soon to be built, and an agreement was entered into to that effect. Jones, however, entered a bid on both jobs and was awarded both contracts. Chambers sued Jones for the profits made under the second contract, alleging breach of the agreement between them. Could Chambers recover? *AI Nov. 1924 (6)*

51. Bishop, a public accountant, desiring to retire from practice, sold all his assets including his good will to Palmer for a stated sum. As a part of the sale Bishop covenanted that he would not engage in the public practice of accounting anywhere for a period of ten years. Is this agreement by Bishop valid? *AI Nov. 1930 (10)*

52. A retail furniture dealer has a business with customers throughout a certain county, but makes no sales outside that county. He sells his entire business and agrees with the purchaser that for a period of five years he will not engage in the furniture business anywhere in the state. Is such agreement enforceable under common law? *AI Nov. 1925 (II-3)*

53. Chandler, owner of a chain of grocery stores in Cleveland, Ohio, sold his entire business to Davison. The contract of sale contained an agreement by Chandler not to engage in the grocery business for a period of ten years. Could Davison enforce the agreement mentioned? What would have been the effect if Chandler had agreed not to engage in the grocery business in Cleveland, Ohio, and vicinity for a period of ten years? *AI Nov. 1923 (5)*

54. Explain what is meant by:

- (a) An executory contract
- (b) An executed contract
- (c) A void contract (Give example)
- (d) An implied contract (" ")
- (e) A voidable contract (" ")
- (f) An express contract
- (g) A covenant

AI Nov. 1917 (9)

55. Distinguish between bilateral contract and unilateral contract. *NY Nov. 1929 (2)*

56. Define:

(a) A joint contract.

(b) A joint and several contract, and point out the rights of the respective parties under each. *AI Nov. 1920 (6)*

57. What is an implied contract? *NY Jan. 1922 (9)*

58. What is a parol contract? Give divisions. *NY Jan. 1918 (1)*

59. *A* calls *B* on the telephone and says: "I have fine apples at \$5.00 a barrel." *B* says: "I will take two barrels."

(a) Is this a good contract?

(b) What effect, if any, would be created if the same words had been expressed in a signed letter by *A* to *B* with *B*'s signed reply?

(c) What additional effect, if any, would be created by a more formal expression of the same conversation in a "memorandum of agreement" signed by both parties and properly witnessed? *AI May 1919 (5)*

60. When is a contract said to be entire? When separable? *AI Nov. 1921 (6)*

61. Hecht purchased from McCormick a team of horses for \$650, a set of double harness for \$185 and a wagon for \$75. Before delivery the harness was stolen. McCormick tendered delivery of the team and wagon, but Hecht refused to accept and pay for them on the ground that McCormick could not deliver the harness also. Was Hecht correct in his position? *AI May 1925 (5)*

62. (a) Where did the statute of frauds originate?

(b) What were the most important provisions of it? *AI May 1932 (7)*

63. State the purpose and the object of the statute of frauds and give one illustration of how it applies. *NY May 1926 (3)*

64. Under the statute of frauds, what contracts must be in writing? *AI Nov. 1923 (6)*

65. *A*, following his discharge in bankruptcy, again entered business and wrote to *B* requesting that *B* sell him a certain quantity of goods to be delivered in monthly installments, *A* to have thirty days in which to pay for each installment. *B* replied, refusing to extend credit to *A* unless *A*'s former indebtedness to *B* were liquidated. *A* then wrote agreeing to pay the former indebtedness in monthly payments until paid in full. *B* then extended the requested credit to *A* in the contract for *A*'s new purchases. Subsequently, *A* defaulted in an installment payment and *B* sued to recover the balance of the old debt. Could he recover? *AI May 1926 (8)*

66. *A* met *B* in March and in the conversation said that he would give *B* \$3600 to act as bookkeeper for a year, *B* to begin work on

May 1. *B* began work on May 1. On August 1 *A* discharged *B* without any cause or reason. What, if anything, could *B* recover in a suit against *A* for breach of contract? *AI May 1926 (9)*

67. John Doe, doing business as a merchant, borrowed money from his bank, which he failed to repay prior to his becoming insolvent. He subsequently went through bankruptcy and was discharged. Believing himself morally, if not legally, indebted to the bank, he, subsequent to the date of his discharge, executed and delivered to the bank a note in payment of his debt. When the note became due, Doe declined to pay it, on the ground that the note was executed without consideration, since it was given to cover a debt that he owed to the bank prior to his discharge in bankruptcy. The bank brought suit to enforce payment of the note. Will it succeed? *NY May 1925 (14)*

68. What simple contracts are required to be in writing? *AI June 1917 (4)*

69. Give an illustration of each of three types of contracts required by the statute of frauds to be in writing. *NY Nov. 1927 (6)*

70. *B* sued *H* for money damages for failure of *H* to manufacture and deliver 2250 men's suits of various sizes and models. *H* signed a memorandum showing number of suits ordered, size and price; the styles and materials were identified by letters, figures and lot numbers used by *H* in his business, and the writing contained all the terms which ordinarily enter into a contract to manufacture and sell except that it contained no statement of the time of shipment or delivery. *H* delivered no goods, nor did *B* make any payments on account. *H* pleaded as a defense the statute of frauds. Who is entitled to judgment? Why? *NY Nov. 1928 (11)*

71. Jones ordered Cleary, a tailor, to make him a suit of clothes at a cost of \$80. Cleary made the suit, but Jones refused to accept it and defended Cleary's action at law, pleading as a defense the statute of frauds. Was this a good defense? *AI Nov. 1926 (6)*

72. What is the parol evidence rule in connection with contracts? State three exceptions to this rule. *NY Nov. 1931 (6)*

73. A contract for the construction of a building recites that the consideration to be paid by the owner shall be "the cost of materials, wages, and direct expenses plus ten percentum of the sum of such costs. Direct expenses shall include the salary of a full-time superintendent and his assistants, the expense of a field officer, employees' compensation insurance, public liability insurance, travel expense, and two percentum per month of the cost of equipment used for wear and tear." Would fire insurance premiums upon equipment be a direct expense to be included? *AI May 1931 (7)*

74. The Apex Importing Company sold to Kerwin certain goods to be shipped during a certain month from a certain country. The goods were purchased with the understanding that "sellers are not to

be responsible for strikes, fires, accidents or anything beyond their control."

Owing to embargoes imposed by the government of the country from which shipment was to have been made, shipment could not be made.

Defendant contended that its failure to deliver was due to something beyond its control, and that the contract was entered into because of a mutual mistake and could not be enforced.

In whose favor will the decision be given? Why? *NY Nov. 1932 (14)*

75. When should the last payment under a building contract be made according to the law of this state? *NY June 1921 (1)*

76. A contract made, executed and delivered in Texas is the subject of a suit in Illinois. The laws of which state govern the validity and construction of the contract? *AI Nov. 1926 (13)*

77. A contract executed and delivered in California is the subject matter of a suit in New York. What laws will govern the validity of the contract, and what laws will govern the remedy? State the rule in such cases. *AI June 1917 (5)*

78. Jones lent Smith \$50. At the time Jones stated that he owed Fisher \$50 which he had promised to pay the next day. Smith, in consideration of the loan, promised Jones that he would pay the \$50 to Fisher the next day, which, however, he failed to do. Fisher sued Smith on Smith's promise to Jones. Could he recover? *AI Nov. 1928 (6)*

79. John Mason at the request of Walter Burroughs lent \$150 to Burroughs, stating at the time that he, Mason, owed that amount to Charles Evans to whom he was obligated to pay it ten days thereafter. Burroughs, in consideration of the loan and at the time of receiving the \$150, promised Mason that he, Burroughs, would pay \$150 to Evans ten days thereafter. Evans knew nothing of this loan and promise until he tried unsuccessfully to collect from Mason. After Burroughs' failure to pay, could Evans recover in an action brought by him against Burroughs? *AI Nov. 1931 (1)*

80. Jones, who rents the apartment in which he lives, holds under a lease running to May 1, 1932. In December, 1931, he calls on Young, a realtor, from whom he expects to purchase a home, to secure a tenant to take over the lease of Jones from January 1, 1932. Brown is secured by the realtor to take over the lease but the landlord refuses to accept Brown and the deal falls through. One week later, the landlord agrees to give a new lease to Brown directly and promises Brown to pay the realtor's commission. The landlord refuses to pay the realtor his commission and the latter brings suit against the landlord. What holding, and why? *NY Nov. 1932 (15)*

81. Williams, a patent lawyer, was rendering legal services to Young on applications for patents which Young had made. Prior to the issues of the patents, Young made a contract with Bostwick whereby Bostwick agreed to conduct and pay for further prosecution of the applications. In this contract no mention was made of Williams or of any other patent lawyer. Williams knew that the contract was made, and in reliance upon it he thereafter rendered legal services in the further prosecution of the applications but without the knowledge or consent of Bostwick or Young. Williams sued Bostwick on the theory that Williams was a third party beneficiary under the contract. For whom should judgment be rendered? *AI May 1934 (1)*

82. Assuming that the entire contract is expressed in the following quotation, state what is lacking to make it a valid contract:

New York, May 1, 1924.

I, John Jones, do hereby assign ten (10) \$1000 Liberty Bonds to a corporation, to be organized for the purpose of receiving the same.
NY June 1924 (7)

83. Give form of assignment of an account. *NY June 1920 (9); NY Jan. 1919 (10)*

84. What right has an assignee under an assignment of lease for debt? *NY Jan. 1920 (5)*

85. State what contracts in general may be assigned and what may not. *AI May 1923 (6)*

86. Can a promisor assign his liabilities under a contract? *AI Nov. 1925 (I-4)*

87. Doran, by a written contract, agreed to sell to Best 200 drums of acid of certain specifications, at the rate of two drums *per diem*, title to pass upon delivery. After delivery the acid was to be sampled and tested and the price fixed according to daily market quotations. Best sold his business, including the contract with Doran, to Trimble, but Doran refused to make deliveries to Trimble who thereupon sued Doran for damages. Is Doran liable? *AI Nov. 1927 (6)*

88. When is time of the essence of a contract (a) at law, (b) in equity? *NY Apr. 1933 (10); AI May 1918 (7)*

89. What is meant (a) by the words "substantial performance" as applied to contracts; (b) by the term "*quantum meruit*"? *AI May 1922 (7)*

90. Jones, a contractor, contracted with Souter to alter and repair a store owned by the latter. He finished the work, but several defects appeared therein. It was shown that the roof was not well supported, that certain doors were not well hung, that one door did not fit its casing. Except for these defects, the work had been well done. Souter refused to pay for any of the work. Jones brought

suit on the contract for the compensation that had been agreed on, less the amount of damages caused by these defects.

Decision for whom, and why? *NY Apr. 1933 (15)*

91. A, a customer of X, gives X a check in payment of the amount owed by him to X. In exchange, X gives A a paid receipt for the debt.

(a) Does the giving of this receipt evidence an intent by the creditor to accept the check in absolute payment? Give reasons.

(b) Would your answer be the same if the check given by A was certified? *NY Apr. 1934 (7)*

92. What is the law relating to the application of payments on account? *NY Jan. 1921 (1)*; *NY Jan. 1920 (15)*; *NY Jan. 1919 (9)*

93. What is the rule for the appropriation of payments made by a person who owes several interest-bearing debts to the same creditor? *AI May 1918 (8)*

94. What is a tender to perform a contract and what is its effect? *AI May 1918 (9)*

95. In June, 1927, H and C agreed in writing, H to sell C and C to buy from H fifty warps of cotton yarn at ninety-five cents per pound, deliveries to start from mill 10% weekly beginning July 1, 1927, "with option to the seller of starting deliveries from the mill at any time seller wished at the rate of 10% weekly." June 18, 1927, H shipped eight warps of cotton yarn. Between June 18, 1927, and August 12, 1927, no shipments were made under the contract, due to freight embargo at point of shipment. During July, 1927, H offered to ship yarn of substantially the same character and quality as that called for in the contract, but this offer was not accepted by C. August 12, 1927, the embargo was lifted and forty-two warps were shipped by H, which C refused to accept and pay for. H sued C for money damages for breach of contract. Can he recover? Give reasons. *NY Nov. 1929 (13)*

96. M had a written contract for certain construction work. For a valuable consideration M, by a sealed instrument, assigned to G a half interest therein, G agreeing to bear one half of the cost of said construction work. Subsequently M and G agreed in writing not under seal to annul the assignment theretofore given G. Thereafter M completed the construction work and subsequent to G's death sued G's executor to recover G's share of the construction expenses under the original contract. Can he recover? Give reasons for your answer. *NY May 1929 (11)*

97. Define: (a) receipt, (b) release, (c) mutual release, (d) general release. Can a release be disturbed? *NY June 1918 (11)*

98. What is (a) a release, (b) a mutual release? In what respect does a release differ from a receipt? Can a mutual release covering past transactions be disturbed? *NY Jan. 1924 (6)*

99. *A* owes *B* \$500. There is no dispute as to the amount owed or about *A*'s liability to pay the \$500 to *B*. *A* pays *B* \$300, and *B* gives to *A* a receipt for the \$300 in which he states that he accepts the \$300 in full discharge of *A*'s obligation to pay the \$500. Later *B* sues *A* for the remaining \$200. Can he recover? *AI May 1928 (6)*

100. Jackson had obtained a judgment against Whitcomb for \$4334.08, but before taking legal steps to collect it he gave Whitcomb a written stipulation wherein Jackson agreed to accept in settlement of the judgment \$1000 in cash (payable in installments), merchandise of the agreed value of \$2300, and an assignment of a certain patent. Whitcomb made and Jackson accepted the cash payments and the delivery of the merchandise, but Jackson refused to accept the assignment of the patent. Could he compel Whitcomb to pay the balance of the judgment? *AI May 1932 (2)*

101. A physician sends a bill for \$500 to a patient as a reasonable value of services rendered, no amount having been agreed on previously. The patient sends \$350 with a note claiming that the charge is excessive but requesting the physician to return the check if it is not satisfactory. The physician fails to do so but notifies the patient that he intends to hold him responsible for the full balance of \$150. The patient failing to pay the balance, the physician sues. Can he recover? Give reasons. *NY Jan. 1916 (8)*

102. Smith & Jones, Certified Public Accountants, completed an engagement for which the fee was not prearranged; they submitted a bill to their client for \$1500, which represented the reasonable value of the services rendered. Doe, the client, on receiving the bill, sent a check for \$850, which he indorsed "in full satisfaction of Smith & Jones Claim." Smith & Jones deposited and collected the check, then sued for the balance. What defenses, if any, had Doe? Give reasons for your answer. *NY June 1923 (8)*

103. Jordan was a salesman on commission with a drawing account. In March, 1932, he was discharged, and a dispute arose between him and his employer as to the amount due him. On April 7, 1932, the employer gave Jordan a cheque for \$390, marked "Final" on its face and endorsed "Payment in full for commissions earned or to be earned and/or all claims to date." Jordan added to this "Also subject to Mr. Jordan's letter of 4/7/32," endorsed the cheque and cashed it. In his letter of April 7, 1932, Jordan wrote his employer that he was "compelled to receive this cheque under protest subject to adjustment of my account." Did Jordan's acceptance of this cheque constitute an accord and satisfaction? *AI May 1934 (6)*

104. Define *account stated*. Give an illustration showing its use. *NY May 1929 (4)*

105. *A*, a carpenter, sent *B* a bill for \$500 for work, labor and services. There had been no agreement as to the price to be paid.

B, on receiving the bill, sent a letter to *A*, not disputing the service, but questioning the reasonableness of the amount of the charge and enclosing a cheque for \$350, which he stated was in full satisfaction of *A*'s claim. *A* made no reply, cashing the cheque. He subsequently sued *B* to recover \$150 as balance due. Is he entitled to recover? *AI May 1920 (5)*

106. What is an account stated? On September 22, a creditor sends *B* a statement of his account. The bill is okayed by *B*, who promises to pay it within a week. A few days later, *B* notifies *A* that some of the goods mentioned in the account are not up to quality and that he will deduct a certain sum from the account. *A* insists on payment in full. Who wins? Give reasons. *NY Jan. 1916 (6)*

107. *A* leased to *B* a wooden structure in the city of Rochester, N.Y., for a period of ten years. The lease contained an agreement on the part of *A* that in case the structure burned during the term of the lease, *A* would rebuild it for *B*'s occupancy with all possible diligence. After about three years the building was destroyed by fire. Meanwhile the city, by an ordinance, had extended its fire limits so as to embrace the property in question, the erection of wooden buildings being prohibited. *B* sued *A* for his failure and refusal to rebuild the structure. Could he recover? *AI Nov. 1922 (5)*

108. A company enters into a contract with *Y* agreeing to manufacture and deliver to him, at an agreed price, 5000 ladies' sweaters, deliveries to be made in equal quantities over a five months' period. Before any deliveries can be made, the company's employees go out on a strike which remains unsettled for a period of two or three months beyond the last delivery date. *Y* is compelled to buy his sweaters in the open market and brings suit to recover damages for the failure of the company to carry out its contract. Can he recover? If so, could the company have protected itself in the contract against such a liability? *AI May 1929 (3)*

109. Charles Little on his own behalf contracted to sell 1,500,000 gallons of molasses of the usual run from a specified sugar refinery, deliveries to begin three months after the date of the contract of sale. At no time did Little have a contract with the refinery. Shortly after deliveries began, the refinery curtailed its output, for economic reasons, although there was no failure of the sugar crop and no fire or other accident or strike at the refinery. The refinery refused to sell to Little a sufficient quantity to enable him to deliver all the 1,500,000 gallons. Has Little any valid defense in an action brought against him by the vendee for failure to deliver? *AI Nov. 1932 (7)*

110. Hughes was a bookkeeper for the Sutton mills, receiving his salary monthly under a contract providing that if he left without giving two weeks' notice he should receive nothing for wages accrued during the current month. On June 14, 1930, Hughes was

arrested, convicted and sentenced to jail. The damage to the Sutton mills from want of notice was greater in amount than one half of Hughes's salary for June. Can Hughes recover his salary for the period from June 1 to June 14? *AI Nov. 1930 (9)*

111. In what ways may a contract be discharged by operation of law? *AI May 1918 (10)*

112. What is the effect on a contract where a party to it (a) is declared a bankrupt and receives a discharge in bankruptcy, (b) makes a general assignment for the benefit of creditors? What, if any, is the distinction between the two cases? *AI May 1927 (4)*

113. A, having contracted on January 1, 1919, to sell B 100 bbls. of flour to be delivered on July 1, 1919, notified B on February 1, 1919 that he would not perform the contract. What were B's rights upon the receipt of this notice? *AI Nov. 1919 (5)*

114. What are general damages and what are special damages for breach of contract of sale? *AI Nov. 1927 (7)*

115. Define the term *liquidated damages* as it relates to a building contract. *NY Jan. 1919 (1)*

116. Wood contracted with Long, a shirtmaker, for 1000 shirts for men. Long manufactured and delivered 500 shirts which were paid for by Wood, who at the same time notified Long that he could not use or dispose of the other 500 shirts and directed Long not to manufacture any more under the contract. Long proceeded to make up the other 500 shirts, tendered them to Wood, who refused to accept, and Long then sued for the purchase price. Could he recover? *AI Nov. 1924 (7)*

117. What is specific performance and when may it be granted? *AI Nov. 1923 (7)*

118. Give an example of a contract on which, in the event of a breach, specific performance would be granted by the courts. *AI May 1929 (14)*

119. Define arbitration and explain how the proceeding is governed. Mention three ways in which an arbitration differs from a reference. *NY June 1932 (10)*; similar questions in *NY June 1923 (1)*, *NY June 1924 (3)* and *NY June 1918 (4)*

120. What is necessary in order properly to prepare and submit the facts in a controversy to an arbitrator, under the laws of the State of New York? *NY June 1924 (1)*

121. When a case has been submitted to an arbitrator in New York, in due legal form, what authority has the arbitrator in connection with the case, both during the trial and afterwards? *NY June 1924 (2)*

CHAPTER III

Negotiable Instruments

257. Scope of chapter. In this chapter we consider the nature and requisites of negotiability and how negotiable instruments differ from ordinary contract obligations; the different types of commercial paper; the manner in which instruments are negotiated and the different kinds of indorsements; the circumstances which make one a holder in due course and the rights and advantages of such holder; the liabilities of the various parties to a negotiable instrument and the defenses which they may have as against such liabilities; the rules governing presentment, dishonor, and protest of negotiable instruments; and the different ways in which a negotiable instrument may be discharged. The more important rules governing checks are also considered.

258. Origin of negotiable instruments: the law merchant. Modern business is characterized by an enormous expansion of credit and a corresponding use of readily transferable ("negotiable") credit instruments as a substitute for money.

Credit instruments are not, however, a recent invention, but an outgrowth of mercantile customs from time immemorial. They were known in early Rome. There is even evidence that some forms of negotiable instruments were in use many centuries ago among the Chinese.

The expansion of international trade following the Renaissance gave new impetus to the need of mercantile paper in place of hazardous gold shipments across pirate-infested waters and over robber-infested lands. Also, mercantile disputes called for legal remedies more suited to the needs of merchants and mariners than those prevailing in the ordinary courts. Mercantile courts—often presided over by arbiters chosen by the merchants and mariners themselves—dispensed quick justice based on the unique body of custom which had grown up outside the ordinary rules of law. In the beginning, the decisions of these "pie counter" courts, as they were called, had no

legal sanction. Later, they were recognized as a valid body of rules based on precedent, and were adopted as the law of the land.

This body of law based on mercantile precedent has come to be known as the law merchant. It embraces not only that branch of the law known as *bills and notes*, or negotiable instruments, but others as well, such as insurance and similar branches of mercantile law.

259. Uniform negotiable instruments law. As with many other branches of the law, the vast body of precedent, much of it conflicting, which grew out of the thousands of judicial decisions on the subject of negotiable instruments, made it necessary to crystallize and codify these precedents into statute form. In 1895, a Uniform Negotiable Instruments Law was framed, and it was ultimately adopted by all the states. (See table on pages 12-13.)

A. Nature and Requisites of Negotiability

260. Nature of negotiability. Negotiability is that quality which permits a written obligation to pass freely from hand to hand as a credit instrument or substitute for money. This quality distinguishes negotiation from assignment. To assign a contract is to pass title to it subject to any burdens or defenses connected with its origin. A negotiable instrument is not thus burdened. It travels freely on its own. It is acceptable on its face.

261. Negotiable instruments and ordinary contracts distinguished. Four characteristics distinguish negotiable instruments from ordinary contracts:

(1) *The right of transfer.* Not all contracts may be assigned (see sec. 209). Negotiable instruments, on the other hand, may be freely transferred.

(2) *Manner of transfer.* A contract may be transferred by any words, oral or written (sec. 205). A negotiable instrument is transferred by indorsement and delivery, or, in some cases, by delivery alone.

(3) *Rights of the transferee.* The rights of a transferee by assignment, i.e., the rights of an *assignee*, can never be greater than the rights of his assignor. The assignee merely steps into the assignor's shoes. If the party obligated to the assignor has any defense to the contract, or any offset against the assignor, he may urge such defense or offset as successfully against the assignee as against the assignor with whom he contracted. This is not true, however, of transfer by negotiation. The transferee of a ne-

gotiable instrument, if he is a holder in due course (sec. 308), acquires his rights in such instrument free from many defenses which might be urged between the original parties.

Examples: I give you a nonnegotiable note. The note is (1) based on fraud, or (2) without consideration, or (3) procured through duress, or (4) given for merchandise not as warranted (thus furnishing an offset on the price), or (5) given for a consideration that fails (unfit merchandise, for example). Any of these facts constitutes a defense not only against you, the payee, but against any subsequent assignee of the note. But if the note were negotiable, and you transferred it to a "holder in due course," he could compel me to pay regardless of such defenses or offsets.

(4) *Consideration.* In respect to consideration, a negotiable instrument differs from an ordinary contract in three ways:

(a) There is no presumption of consideration in an ordinary contract, such as a nonnegotiable instrument, but every negotiable instrument is deemed *prima facie* (that is, unless and until the contrary is shown) to have been issued for a valuable consideration.

(b) An ordinary contract based upon past consideration is unenforceable, but a negotiable instrument is valid though based upon past consideration.

(c) The assignee of a contract lacking consideration acquires no greater rights than his assignor. As noted in (3) of this section, this is not true where a negotiable instrument is acquired by a holder in due course.

262. Requisites of negotiability. The Negotiable Instruments Law provides that an instrument to be negotiable must conform to the following requisites:

(a) It must be in writing and signed by the maker or drawer;

(b) It must contain an unconditional promise or order to pay a sum certain in money;

(c) It must be payable on demand, or at a fixed or determinable future time;

(d) It must be payable to order or to bearer; and

(e) Where the instrument is addressed to a drawee, he must be named or otherwise indicated therein with reasonable certainty.

263. Instrument must be in writing. The instrument may be handwritten in ink or pencil, typewritten, lithographed, engraved, printed, or stamped.

264. Instrument must be signed by maker or drawer. A note is signed by a "maker," a draft (bill of exchange) by a "drawer." The signature must be intended as such, and must consist of a name, an initial or initials, a mark ("X"), or a trade, assumed, or fictitious name. It may be written, typewritten, mimeographed, lithographed, or printed.

No person is bound on an instrument unless his name is on it. /

Signature by agent. If an agent, John Mason, signs for a principal, Henry Brown, he should sign, "Henry Brown, by John Mason, Agent," not "John Mason, Agent." Otherwise, he may become personally liable to a holder in due course. However, as to a payee, the rule is somewhat different. Where a person signs as agent without disclosing his principal and the payee knows that he is acting as agent and does not intend to bind himself individually, the agent is not personally liable to the payee if he was authorized to sign for the principal; and the principal is not liable in such case either, since his name is not on the instrument. If the agent signs without authority, he is personally liable. If he signs for a non-existent or incompetent principal, he is also liable.

An agent's authority to execute and deliver negotiable instruments need not be in writing.

Signature by procuration. A signature "by procuration" serves as notice that the agent has only limited authority to sign and that the principal is not bound if the agent exceeds his authority.

Signature by corporation. A signature in the corporate name only, or in a corporate name by an officer or agent, is binding on the corporation if actually or ostensibly authorized. There are cases which hold, however, that where a note is signed, not in the name of a corporation, but in the name of an officer, with an addition of the office he holds, the officer is personally liable. This is true even where the corporate name is printed in the margin of the instrument.

265. Unconditional promise or order. The promise (note) or order (bill) must not depend on any contingency, such as a promise or order to pay out of a particular fund. But a promise or order to pay is not conditional merely because it is coupled with an instruction to "charge" the payment to a particular fund or account. Neither is the unconditional character of a promise affected by a guaranty indorsed on the instrument, or by a provision adding costs of collection and attorney's fees in case of suit. Where the promise or order is subject to a contingency, it is immaterial that the contingency afterwards happens: the instrument is nonnegotiable. A promise or order conditional upon the terms of another instrument or contract renders the instrument nonnegotiable, but a mere reference to some other instrument or contract is immaterial.

266. Sum certain in money. "Money" means an acceptable medium of exchange, not necessarily legal tender. It excludes gold or silver bullion, bonds, notes, checks (certified or uncertified), goods, "solvent cash notes," scrip, and so on. The

promise or order may be to pay in a particular kind of money, or in coin, or some particular kind of coin, such as "gold dollars" or "United States gold coins." The instrument need not be payable in American money.

A sum is certain even though payable in installments, with interest on unpaid installments and with a promise that on default in payment of either the whole becomes due. A provision adding taxes, however, makes the sum uncertain and the instrument nonnegotiable.

267. On demand. An instrument is payable on demand:

- (a) If it so states; or
- (b) If it is payable "on presentation" or "at sight"; or
- (c) If it expresses no time for payment.
- (d) If a person issues, accepts, or indorses an instrument after it is overdue, the instrument, as to him, is payable on demand. Thus, if I indorse a note today that was due yesterday, such note, as to me, is payable on demand.

268. "Fixed or determinable future time." An instrument must be payable at a fixed future time or at a *determinable* future time (one that is certain to come): "Thirty days after my death," for example, but not "thirty days after my marriage" or "thirty days after receiving a share of my father's estate."

"Time note." A note payable in the future, as distinguished from a demand note, is known as a "time note."

269. "To order or to bearer." These are known as *words of negotiability*. An instrument payable *to a person* instead of *to his order* is not negotiable, but if it is payable *to a person or his order*, or *to a person or bearer*, or *to the order of a person*, or simply *to bearer*, the instrument is negotiable.

The instrument need not follow the exact language of the statute. Hence, the words "negotiable and payable without defalcation," following a promise to pay "to John Smith," would probably suffice as words of negotiability.

An instrument payable in the alternative ("to the order of James G. Kelly *or* Charles Perkins") is not negotiable.

An instrument is payable to bearer:

- (a) When it so provides; or
- (b) When it is payable to a person or bearer; or
- (c) When it is payable to cash; or
- (d) When it is intentionally made payable to a fictitious or nonexistent

person, or to a bookkeeping account (such as Payroll, Petty Cash, Sundries, and so on); or

(e) When the payee's name does not purport to be the name of any person; or

(f) When the only or last indorsement is in blank (sec. 299).

But an instrument payable to a particular bearer ("Pay to bearer, Claude Nelson") is not negotiable.

270. Specific designation of drawee. If an instrument is addressed to a drawee, he must be named or otherwise indicated therein with reasonable certainty. A bill of exchange addressed "To Whom It May Concern" would therefore not be negotiable.

271. Factors which affect negotiability. Any factors which violate the foregoing requisites necessarily prevent negotiability. A negotiable instrument must not contain a promise or order to do any act in addition to the payment of money, such as a promise to deliver merchandise or render services. Four exceptions to this rule are:

(1) A provision which authorizes the sale of collateral securities in case the instrument is not paid at maturity.

(2) A provision which authorizes a confession of judgment if the instrument is not paid at maturity.

(3) A provision which waives the benefit of any law intended for the advantage or protection of the obligor.

(4) A provision which gives the holder an election to require something to be done in lieu of payment of money.

272. Factors which do not affect negotiability. Negotiability is not affected by unessential omissions or by the inclusion of matter which does not affect the promise or order.

Unessential omissions. An instrument is negotiable though the following be omitted: (a) date, (b) "value received," (c) place where instrument was drawn, (d) place where instrument is payable, and (e) provision for interest.

Language not affecting the promise or order, and not constituting a promise or order to do something additional, does not affect negotiability.

Examples:

(1) A statement of the transaction which gave rise to the instrument. (See sec. 1458.)

(2) A provision that the article sold is to remain as security until the instrument is paid.

273. Examples of negotiability. Following are examples of language which does not violate the rules of negotiability:

- (a) Promise to pay in wheat or money, at *holder's option* (sec. 1452).
- (b) "The obligation of the acceptor hereof arises out of the purchase of goods from the drawer."
- (c) "In case this note is collected by an attorney . . . the maker hereof agrees to pay a reasonable attorney's fee."
- (d) Promise to pay \$50,000 "in successive semiannual payments of not less than \$1000 each for eight years, balance on demand thereafter."
- (e) "With interest on unpaid principal at the rate of 6% per annum payable semiannually."
- (f) "Pay to the order of . . . on account of contract between you and the undersigned."
- (g) "On account of 14,789 bags Cuban centrifugal sugar as per contract 4/25/48" (sec. 1458).
- (h) "The piano for which this note is given shall remain the seller's property until note is paid with interest."
- (i) "I promise to pay . . . for the amount of the second installment on machine purchased this date."
- (j) "Thirty days after the death of William Smith, I promise to pay to the order of"

274. Examples of nonnegotiability. Following are examples of language which renders an instrument nonnegotiable:

- (a) "Pay to C. Jones" (sec. 1452). (*Not payable to order or bearer.*)
- (b) Promise to pay "ten ounces in gold" (sec. 1452). (*Not payable in money.*)
- (c) "I have this day borrowed \$5000 from Alfred K. Brown, which sum is subject to and payable on demand." (*Not payable to order or bearer.*)
- (d) "I, A, hereby acknowledge my indebtedness to G for services rendered by him, for which I promise to pay him the sum of \$10,000." (*Not payable to order or bearer.*)
- (e) "Sixty days after my arrival in London, I promise to pay to the holder, James Gray, \$500 for value received." (*No certain maturity, and not payable to order or bearer.*)
- (f) "I promise to pay James Jones or order \$1000 when he becomes twenty-one years of age." (*No certain maturity.*)
- (g) Promise to pay \$12,000 in twelve equal monthly payments of \$1000 each, with interest on unpaid installments, "together with all taxes assessed upon said sum against said payee or holder of this note." (*Sum not certain.*)
- (h) "As security for this note, I agree to deposit pass book No. 15043, issued by your compound-interest department in my name, and to deposit therein \$18 on the 15th of each month until the face amount of this note has been deposited." (*Promise to make deposits is promise to do additional act.*)

275. Factors which destroy negotiability. An instrument that is negotiable may lose its negotiability in three ways: (1) by restrictive indorsement (sec. 301); (2) by arrival at maturity (sec. 308, subd. (2)); and (3) by discharge (sec. 373).

276. Validity *v.* negotiability. The mere omission of a requisite to negotiability will not destroy the validity of an instrument. Instruments may lack negotiability, yet be fully enforceable as contract obligations. In *Matter of Nellis*,¹ the maker signed a paper designated "Demand Note," which read as follows: "This is to certify that I, William J. Collins of New York City, have this day and date borrowed in cash and received in currency the sum of Five Thousand Dollars from one of my friends, Alfred K. Brown of Albany, N.Y., which sum is subject to and payable on demand, with interest at the rate of 6% per year." The Court held that this was not a negotiable promissory note because there was no promise to pay to order or to bearer. However, from the fact that the paper was designated "Demand Note," and that it clearly implied a promise to repay monies, the Court further held that the paper was a good *promissory note*, hence that there was no good reason why the payee could not collect it.

277. Ambiguous instruments: rules of construction. The Uniform Negotiable Instruments Act provides that when the language of an instrument is ambiguous, or there are omissions therein, the following rules of construction apply:

(a) When the sum payable is expressed in words and also in figures and there is a discrepancy between the two, the sum denoted by the words is the sum payable; but if the words are ambiguous or uncertain, reference may be had to the figures to fix the amount (see sec. 1459).

(b) When the instrument provides for the payment of interest, without specifying the date from which interest is to run, the interest runs from the date of the instrument, and if the instrument is undated, from the issue thereof.

(c) When the instrument is not dated, it will be considered to be dated as of the time it was issued.

(d) When there is a conflict between the written and printed provisions of the instrument, the written provisions prevail.

(e) When the instrument is so ambiguous that there is doubt whether it is a bill or note, the holder may treat it as either at his election.

(f) When a signature is so placed upon the instrument that it is not

¹ 126 Misc. 638.

clear in what capacity the person making the same intended to sign, he is to be deemed an indorser.

(g) When an instrument containing the words, "I promise to pay," is signed by two or more persons, they are deemed to be jointly and severally liable thereon. (See section 175.)

278. Presumption as to date. Where an instrument or its acceptance (sec. 340), or any indorsement on it, is dated, such date is deemed *prima facie* (that is, unless the contrary can be shown) to be the true date it was made, drawn, accepted or indorsed.

B. Types of Credit Instruments

279. In general. Broadly, negotiable instruments fall into two classes: *Promissory notes* and *bills of exchange* (*notes* and *bills*, for short). Notes take various designations and forms, such as bank notes, certificates of deposit and bonds. Variations of bills include drafts, checks, bank drafts, letters of credit, traveller's checks, trade acceptances and money orders. In addition to bills and notes, there are certain types of instruments possessing negotiability or quasi negotiability and commonly designated *documents of title*, such as bills of lading, warehouse receipts and trust receipts.

280. Promissory notes. In a promissory note one party, the "maker," promises to pay a sum of money to another party, the "payee," or to his order, or to bearer. The promise need not be expressed; it may be implied from any language that imports a promise to pay or repay money. A note may be signed by a single individual, or it may be joint, or joint and several (secs. 175 and 277, subd. g).

Note to maker's order. A note drawn to the maker's own order is not complete unless indorsed by him.

Note payable at bank. A note payable at a bank is equivalent to an order on the bank to pay the money on due date.

Simple v. collateral note. A simple note is an ordinary, unsecured note. A collateral note is one which recites that it is secured by some form of collateral, with authority to the payee in case of default to sell the collateral and apply the proceeds to the payment of the note.

Bank note. A bank note is a note issued by a bank or banker authorized to do so, payable to bearer on demand and intended to circulate as money.

Judgment note. A judgment note is one which authorizes a confession of judgment on behalf of the maker in case of default, namely, a formal statement on which a judgment may be entered without trial; so that

a judgment may in such case be entered against the maker without suit for the amount of the note with interest, attorney's fees and costs.

Due bill. A due bill is an acknowledgment of indebtedness in a specified sum, from which a promise to pay may be inferred. If the requisites of negotiability are present, the due bill is negotiable. For example: "Jan. 5, 1948. Due A. B. or order, on demand, One Hundred Dollars. Signed, C. D." If the due bill specifies no due date, it is payable forthwith, though no demand was made.

Certificate of deposit. A certificate of deposit is a writing signed by a bank acknowledging receipt of a sum of money payable to the depositor or his order at a time specified in the certificate. It enables one to make a temporary interest-bearing deposit in a bank for safekeeping, without opening a savings or checking account; and if it has the requisites, it may be used as a negotiable instrument. (See sec. 1461.) For a specimen certificate of deposit, see section 1461, and question 41 on page 200.

Bond. A bond is an acknowledgment under seal of an obligation to pay a fixed sum of money. The obligation may be conditional, as in the case of an indemnity or penalty bond, or it may be unconditional, as in the case of a simple bond for the payment of a definite sum of money to bearer or a named obligee on demand or on a day certain, with interest at fixed intervals. The latter type of bond is commonly issued by business or municipal corporations and by governments generally for the purpose of long term loans.

Bearer bonds (usually with interest coupons attached) are negotiable by delivery. If bearer bonds are lost or stolen, the finder or thief may pass good title to an innocent purchaser for value.

Registered bonds are transferable only by indorsement, and by registration of the transferee's name on the books of the government or corporation issuing the bonds; hence, not negotiable.

Some statutes permit the owner of a bearer bond to render it nonnegotiable by writing his name on it, with a statement that he owns it.

281. Bills of exchange. A *bill of exchange* or *draft* consists of a written order addressed and signed by one party (the drawer) to another party (the drawee) requiring the latter to pay a third party (the payee), or his order, a sum of money. If the drawee "accepts" (sec. 340), he becomes the acceptor. Such an instrument, having three parties, is called a *three-party draft*.

Two-party draft. A draft made payable by the drawer to himself as payee (for collection purposes) is known as a *two-party draft*.

A *domestic* or *inland* bill or draft is one drawn and payable in the same state; all others are *foreign*.

A *sight draft* is a bill of exchange payable at sight, as distinguished from a *time draft*, which is payable at a fixed time *after date* (that is, after the date of the instrument), or *after sight* (that is, after the instrument has been presented to the drawee for acceptance).

A *documentary sight draft* is one which is accompanied by documents, such as bills of lading or warehouse receipts (secs. 283-284) in connection with which the draft is drawn.

Checks. A check is a bill of exchange drawn on a bank and payable on demand. Checks are further discussed on pages 186-194.

Bank draft. A bank draft is a check by one bank on another. It is distinguishable from a *cashier's check* which is drawn by a bank upon itself, signed by the cashier, and payable to another.

Trade acceptances. A trade acceptance is a two-party time draft, drawn by a seller upon a purchaser, payable to the seller as payee, and accepted by the purchaser as evidence that the goods shipped are satisfactory and that the price is due and payable. A trade acceptance has two advantages over a note: (1) It gives the seller a better assurance of payment, because it carries proof of the transaction for which it was accepted, and the acceptor's satisfaction therewith; (2) it is more readily discountable through banking channels, because it is rediscountable at a Federal Reserve bank provided its maturity is not more than ninety days.

Money orders. A money order is an order for the payment of a specified sum of money to the order of a specified person, drawn by a post office or express office, and payable respectively at any other post office or express office. Only one transfer by indorsement is permitted on a money order.

Letters of credit. A letter of credit is a letter, either generally or specifically addressed, requesting that money be advanced or credit given to the bearer, and promising or guaranteeing repayment of the moneys advanced.

Traveller's letters. Letters of credit are frequently used by travellers who, upon presenting the letters to express offices, banks or similar institutions, may obtain funds as and when needed, up to the full amount specified in the letter, by signing checks or drafts for the particular amounts required.

Traveller's checks. Traveller's checks are a simplification of traveller's letters of credit. They consist of checks in convenient denominations purchased by a traveller from a bank or express company, payable to the order of the traveller upon his signature in the presence of the person who sells the checks, and upon his countersignature in the presence of the person cashing it. Traveller's checks are popular because they are readily acceptable in this country or abroad and can be easily cashed.

Commercial letters of credit. Letters of credit are also frequently used by merchants, particularly exporters. The purchaser may be unwilling to pay for a shipment in advance; the seller may be unwilling to ship without assurance of payment. A letter of credit facilitates the transaction. The purchaser's bank notifies the seller's bank that a letter of credit has been opened against the transaction, and the seller's bank utilizes the credit by drawing a draft on the purchaser's bank, accompanied by shipping documents, which may be delivered to the purchaser upon acceptance of the draft. The seller is protected by having a responsible source of payment; the purchaser, by making payment only against the documents of title.

A *clean letter of credit* is a statement that a credit for a certain sum has been drawn upon in favor of the seller, which will be paid against the seller's draft; that is, the seller is not required to present any shipping documents but may simply draw his draft. A clean letter of credit is as a rule confined to transfers of funds between branch establishments.

A *documentary letter of credit* requires that the draft drawn against the credit established be accompanied by evidence of the shipment, such as bills of lading, invoices, and so on. Frequently documentary letters of credit contain specific conditions in respect to the quality and quantity of the merchandise, a specified time within which shipment and delivery must be made, and so on.

282. Documents of title. A document of title is one which confers upon the holder the right of ownership, possession or transfer in respect to merchandise therein specified. Strictly speaking, documents of title are not negotiable instruments since they do not call for the payment of money. They are sometimes called *quasi-negotiable instruments*. They are invested by statute (*Uniform Bills of Lading Act* and *Uniform Warehouse Receipts Act*) with certain characteristics of negotiability (sec. 509). Two common examples are *bills of lading* and *warehouse receipts*. Other evidences of ownership possessing quasi-negotiable characteristics are *trust receipts* and *certificates of stock*.

283. Bills of lading. A bill of lading is a receipt issued by a carrier for merchandise shipped. "Order bills of lading" are said to be negotiable; "straight bills of lading," not. The word "negotiable," in this connection, does not have the same meaning as when applied to instruments for the payment of money.

An *order bill of lading* is one which recites that goods are consigned to the order of a person named therein, hence is negotiable by indorsement and delivery.

A *straight bill of lading* is one which recites that goods are consigned to a specified person, hence is not negotiable.

Bills of lading are discussed more fully in sections 597 to 604 inclusive.

284. Warehouse receipts. A warehouse receipt is a receipt issued by a warehouseman against goods accepted for storage. If deliverable to the order of a person named therein, the instrument is negotiable by indorsement and delivery and may be freely bought, sold or pledged. (See sec. 484.)

285. Trust receipts. A trust receipt is an instrument of commerce by which a bank advancing money to enable a cus-

tomer to purchase goods takes the bill of lading for such goods in its own name and thereafter surrenders possession to the customer under an agreement that the title to the goods shall remain in the bank and that the proceeds of the sale shall be applied to the repayment of advances made by the bank on account of the original purchase price. The trust receipt secures the bank against the merchandise thus surrendered to the customer. (See sec. 451.)

286. Certificates of stock. A certificate of stock represents ownership, not an unconditional promise or order for the payment of money. However, under the Uniform Stock Transfer Act it possesses negotiability to the extent that if it is indorsed in blank by the owner, an innocent purchaser for value gets good title though the certificate was lost, stolen, or procured from the owner by fraud, duress, mistake, or otherwise without his true consent. Hence the negotiability of a certificate of stock, including the rights of an innocent purchaser for value, depends upon whether or not the corporation issuing the certificate is organized under the laws of a state recognizing the Uniform Stock Transfer Law (see table on pages 12-13).

Example: If a stockholder loses his certificate after indorsing it in blank, and the finder (or a thief) sells it to an innocent purchaser for value, the latter gets good title, or he does not, depending (respectively) on whether the corporation issuing the certificate was, or was not, organized in a state which has adopted the Uniform Stock Transfer Law.²

However, the Uniform Stock Transfer Act has no application where a finder or thief alters the stock certificate before transferring it: an innocent purchaser for value gets no title in such case. (See sec. 334, subd. (B) (4).)

C. Issue

287. Birth of liability. Issue marks the birth of liability. Until an instrument is issued, it has no more effect than any other undelivered contract.

288. Issue defined. The statute defines issue as "the first delivery of an instrument, complete in form, to a person who takes it as a holder." Emphasis is placed on two requisites governing the issuance of an instrument: (1) It must be complete in form; and (2) it must be delivered.

² *United States F. & G. Co. v. Newburger*, 263 N.Y. 16; *Place v. Chaffee*, 251 Mass. 508, 511, 146 N.E. 722; *Crichton v. Louisiana Oil Refining Co.*, 144 La. 649, 81 So. 213.

289. Date of issue. The date of delivery of an instrument is the date of its issue, regardless of the date on the instrument or the absence of any date. The payee acquires title as of the date of issue.

Antedating or postdating an instrument does not alter the fact that the payee acquires title when the instrument is actually issued.

Example: If Jones issues a thirty-day note on May 1 and postdates it May 10, his death on May 3 does not invalidate the note, though it is dated a week later.

290. Right to supply missing date. Where an undated instrument is expressed to be payable a fixed period after date or after sight, any holder may insert the true date of issue or acceptance, and the instrument becomes payable accordingly. A wrong date, if inserted, is deemed the true date only as to a holder in due course.

Example: I give you an undated note payable ninety days after date; or I draw a draft upon William Smith in your favor as payee, payable ninety days after "sight" (that is, ninety days after its acceptance by Smith), and Smith accepts without dating his acceptance. You or any subsequent holder may insert the correct date of issue or acceptance, respectively. If you insert the wrong date, it will be deemed the true date only as to a holder in due course.

291. Instrument must be complete in form. Valid issue requires that the instrument be complete in form. No liability arises on an incomplete instrument, except where the law presumes authority to complete the instrument.

Filling in blank spaces. Where an instrument is wanting in any material particular, the person in possession of it has *prima facie* authority to complete it by filling up the blanks. In order that such instrument may be enforced against a person who becomes a party to it before it is completed, it must be completed strictly in accordance with the authority given, and within a reasonable time; otherwise such person will not be liable, except to a holder in due course.

Example: Jones gives his bookkeeper two signed notes with the amounts and names of the payees' blank. He instructs the bookkeeper to fill in the names of two creditors as payees, with the correct amounts as shown by invoices on file (\$100 and \$200, respectively). The first note is negotiable; the second, not. The bookkeeper wrongfully fills in the amount of \$1000 on each note. He issues the first note to Smith, a holder in due course, and the second note to Brown who is not a holder in due course because the note is nonnegotiable. Jones would be liable to Smith, but not to Brown.

Signature on blank paper, delivered. Where a person signs his name on a blank paper which he delivers with instructions to convert it into a negotiable instrument, he is liable on it only if it is filled in pursuant to authority; except that as to a holder in due course, he is liable on it whether it was filled in pursuant to instructions or not.

292. Delivery: instrument complete in form. As stated in section 288, issue means the first delivery of an instrument, complete in form, to one who takes it as a holder. If such an instrument is delivered to one not as holder (an agent or custodian, for instance), it is as if the maker or drawer still had it in his own possession. When such instrument is no longer in the hands of a person who makes, draws, accepts or indorses it, a valid delivery will be presumed in the absence of proof to the contrary. If proof to the contrary is shown, namely, that there was no real delivery, or that the delivery was conditional, or for a special purpose, there is no liability. However, if the instrument gets into the hands of a holder in due course, no such proof may be shown, for as to him, delivery of a completed instrument is conclusively presumed.

Example: Bacon makes a nonnegotiable note payable to bearer and leaves it on his desk. A gust of wind blows it out of the window. Johnson finds it and transfers it for value to Hall. Hall cannot collect the note, because as to him, Bacon may show that there was no delivery. But if the note were negotiable and Johnson transferred it to a holder in due course, the latter could collect it, because as to him, delivery would be conclusively presumed.

293. Incomplete instrument: no presumption of delivery. When an *incomplete* instrument leaves one's possession, there is no presumption of delivery. Lack of delivery in such case may be shown even as against a holder in due course.

Example: Take the example in section 292. If, when Bacon left the note on his desk, it was incomplete as to amount, or due date, or in any other respect, even a holder in due course could not hold Bacon on the note.

Signature on blank paper, not delivered. When a person scribbles his name on a blank sheet of paper, and someone, without authority, fills in a negotiable instrument over the signature and negotiates it, no liability attaches to such signature, even when an innocent person gives value for the bogus instrument. No presumption of delivery can arise in such case.

D. Negotiation

294. Issue *v.* negotiation. Strictly speaking, an instrument is not "negotiated" until it leaves the hands of the payee, or

person to whom it is issued. If I make a note to your order and deliver it to you, the note is issued, but it is not yet negotiated. In other words, as between you and me (the "immediate" parties), the instrument is still an ordinary contract.

Negotiation is the subsequent transfer by the payee to a third party, by the latter to a fourth, and so on. Such transfer creates certain rights and obligations peculiar to the law governing negotiable instruments.

295. Negotiation: definition and process. The statute defines negotiation as so transferring an instrument "as to constitute the transferee the holder thereof." Only the entire amount of an instrument can be negotiated.

An instrument, if payable to order, is negotiated by indorsement and delivery; if payable to bearer, by delivery alone.

296. Indorsement: what constitutes. Indorsement is writing one's name, with or without additional words, either on the instrument itself or, if it is too crowded, on an *allonge*, or paper attached to the instrument. One usually indorses on the back of the instrument; but as stated in sec. 277, subd. (f), if one puts his signature anywhere on the instrument he is deemed to be an indorser unless he clearly indicates his intention to be bound in some other capacity.

Typewritten indorsements are valid.

Words of negotiability unnecessary. An indorsement need not contain words of negotiability ("order" or "bearer").

Misspelled names. Where the name of a payee or indorsee is wrongly designated or misspelled, he may so indorse the instrument, adding, if he wishes, his proper signature.

297. Indorsement v. guaranty. An indorsement is governed by the Negotiable Instruments Law; a guaranty is not. Thus, an indorser is discharged if the holder fails to make proper presentment (sec. 335) and to serve notice of dishonor (sec. 357). A guarantor is not thus protected.

298. Kinds of indorsements. Indorsements may be *in blank*, *special* or "*full*," *restrictive*, *qualified*, *conditional*, and *irregular* or *anomalous*.

299. Indorsement in blank. An indorsement in blank, or "general" indorsement, specifies no indorsee and consists merely of the indorser's signature. Such an indorsement makes the instrument payable to bearer; that is, it may be negotiated by delivery without further indorsement.

Example: A mere signature, "Walter Watson," on the back of an instrument, constitutes an indorsement in blank.

300. Special indorsement. A special, or "full" indorsement, specifies a person to whose order the instrument is payable.

Example: "Pay to the order of Sarah Jane Moore. Walter Watson."

The effect of a special indorsement is to require the indorsee's signature (Sarah Jane Moore) before the instrument can be further negotiated. In this respect it has an advantage over an instrument indorsed in blank. If the latter is lost or stolen, an innocent purchaser of it for value and before maturity may collect the instrument from the maker, and the indorser (Watson) would then have no remedy except against the finder or thief. This is because a blank indorsement converts the instrument into bearer paper negotiable by delivery; and delivery, as to a holder in due course, is conclusively presumed (sec. 292). A special indorsement has the added advantage that it provides a record of payment where the holder of an instrument uses it to pay a debt.

301. Restrictive indorsement. A restrictive indorsement is one which "restrains the negotiability of the instrument to a particular person or for a particular purpose."³ It (1) prohibits further negotiation, or (2) makes the indorsee the indorser's agent, or (3) vests title in the indorsee in trust for or to the use of another.

Examples:

(1) "Pay to Sarah Jane Moore only. Walter Watson."

(2) "Pay to the Transcontinental Trust Company for collection. Walter Watson."

(3) "For deposit only. Walter Watson."

A restrictive indorsement serves notice on all subsequent parties of the purpose specified in the indorsement.

Example: If Moore, payee of a note, indorses it "Pay to Neil Bartlett for collection," he serves notice that he has not parted with title to the instrument but has merely made Bartlett his agent for collection. If Bartlett indorses to Fred Downs, and Fred Downs collects the note, he holds the proceeds as trustee for Moore.

302. Qualified indorsement. A qualified indorsement is one which qualifies the indorser's liability and limits his function principally to that of an assignor. Such an indorsement, how-

³ 10 *Corpus Juris Secundum* 704.

ever, in no way limits the further negotiation of the instrument.

Example: "Without recourse. Walter Watson."

The statute says that if an indorser wishes to qualify his liability to a subsequent holder, he must use the words "without recourse" or words "of similar import."⁴ Words of assignment, the courts hold, are not words "of similar import."

Example: The payee of a note, before maturity, wrote on the back of it: "I hereby assign all my right and interest in this note to Richard Fay in full. (Signed) Henry C. Witte." The maker defaulted and Fay sued Witte as indorser. Witte denied liability, claiming that he was a qualified indorser. The Court held that if an indorser wishes to qualify his liability, he must use the words "without recourse" or words "of similar import," adding: "This indorsement contains no such words."⁵

The foregoing decision represents the majority rule. The courts in some states⁶ hold that words of assignment constitute a qualified indorsement.

303. Conditional indorsement. A conditional indorsement renders the indorser liable only upon a specified condition or conditions.

Examples: "Pay to Dixie Cotton Company against my receipt for thirty-two standard bales cotton, Snow White brand"; or "Pay to King Coffee Growers Ass'n upon delivery of warehouse receipt for twelve sacks of Blended Ambrosia Coffee."

304. Irregular (anomalous) indorsement. An irregular or anomalous indorsement is one made by a third person (other than the payee or holder), who writes his name (with or without additional words) on the back of an instrument for a purpose other than to transfer title to the instrument. Such indorsement, which transfers no title in the instrument, is distinguishable from a *regular* indorsement, which transfers title. The usual purpose of such an indorsement is to lend credit by way of accommodation.

Example: Tompkins makes a note payable to the order of the First National Bank, and before delivery Chase writes his name on the back of it.

⁴*Stover Bank v. Welpman*, (Mo.) 284 S.W. 177, transferred 323 Mo. 234, 19 S.W. 2d 740; *Kennedy v. Hudson*, 224 Ala. 17, 138 So. 282; *Walter v. Kilpatrick*, 191 N.C. 458, 132 S.E. 148; *Smith v. Fulton*, 51 Ohio App. 12, 199 N.E. 218; *Copeland v. Burke*, 59 Okl. 219, 158 P. 1162; *Howard v. Kincaid*, 54 Okl. 271, 156 P. 628.

⁵*Fay v. Witte*, 262 N.Y. 215.

⁶Including California, Illinois, Michigan and North Carolina.

305. Mixed classification of indorsements. The foregoing classifications of indorsements are not necessarily mutually exclusive. For example, a restrictive or qualified indorsement may be either in blank, or special, as in the following illustrations:

Restrictive (in blank): "For deposit only." *Frank White*

Restrictive (special): "Pay to the order of Transcontinental Trust Company, for deposit only." *Frank White*

Qualified (in blank): "Without recourse." *Frank White*

Qualified (special): "Pay to the order of Sarah Jane Moore, without recourse." *Frank White*

306. Indorsement by infant or corporation. The Uniform Negotiable Instruments Law provides that infants or corporations may pass title to an instrument by indorsement, notwithstanding that from want of capacity they may not be liable on it.

Example: A note payable to Allen is indorsed by him to Ball, an infant, and by Ball to Cole. The maker defaults, and Cole sues Allen and Ball as indorsers. Ball's defense is infancy; Allen's, that Cole acquired no valid title because of Allen's infancy. Ball's defense is good; Allen's bad.

A similar rule would apply where a corporation indorses an instrument without power to do so and hence without liability (sec. 886), or without consideration so that the indorsement amounts to an accommodation and is unenforceable (sec. 883).

E. Holder in Due Course

307. Transfers in due course. The essence of negotiability, as noted in section 260, is that an instrument shall circulate freely; that one may take the instrument on its face, without concern as to possible personal defenses to which assignees are subject (sec. 206). One who acquires an instrument with these immunities of negotiability is known as a *holder in due course*.

308. When person is a holder in due course. A holder in due course is one who acquires a negotiable instrument under the following conditions:

(1) *That it is complete and regular on its face.* If one takes a note in which some material item (such as maturity, amount or signature) is omitted, incomplete or irregular, he is not a holder in due course. A purchaser of an instrument with unfilled blanks is put on inquiry; he is not a holder in due course.

(2) *That he became the holder of the instrument before it was overdue and without notice that it had been previously dishonored if such was the fact.* If one takes a note on June 15th which was due the day before, he cannot be a holder in due course.

(3) *That he took the instrument in good faith and for value.* If the person who takes a negotiable instrument either knows, or suspects, or has reason to know or suspect some condition or circumstance which might justify a refusal to pay the instrument—such as that the instrument was issued without consideration or procured through fraud—he cannot be said to have taken the instrument in good faith. Knowledge or notice of an agent, in this connection, is knowledge or notice of the principal.⁷ (See section 573.)

(a) *Value.* Anything constituting consideration (sec. 146) constitutes value. Giving another instrument for the one acquired constitutes giving value for it. If I give your note to my bank and take for it a certificate of deposit payable after your note is due, the bank has given me value and is a holder in due course.

(b) *Holder for value.* Ordinarily, a person must give value for an instrument to be a holder for value. However, the Negotiable Instruments Law provides that where value has at any time been given for the instrument, the holder is deemed a holder for value in respect to all parties who became such prior to that time.

(c) *Pledgee as holder for value.* When a note is taken as collateral security for a debt, the transferee is a holder for value to the extent of the debt secured. (See sec. 1468.)

(4) *That at the time the instrument was negotiated to the holder, he had no notice of any infirmity in the instrument or defect in the title of the person negotiating it.* Notice of infirmity or of defect in title means actual knowledge of it, or knowledge of such facts that one's action in taking the instrument amounts to bad faith. "Infirmities" may be obvious from an inspection of the instrument, such as errors, omissions or other irregularities on its face, or they may not be apparent from an inspection, such as defects in the title of a prior holder.

When transferror's title is defective. The title of a person who negotiates an instrument is defective when he obtains the instrument, or any signature to it, by circumstances amounting to fraud, duress or other unlawful means or for an illegal consideration or in breach of faith.

309. Rights of holder in due course. As a holder in due course, the purchaser of a negotiable instrument may acquire rights greater than the vendor had. A holder in due course may enforce collection of the instrument against prior parties regardless of their claims, defenses and offsets against one another (except for *real* or *absolute* defenses, such as forgery, and so on, explained in sec. 334). The maker, for example,

⁷ *International Harvester Co. v. Carruth* (La.), 23 So. 2d 473.

may have given the note to the payee without getting anything for it; or he may have a claim or offset against the payee equal to or greater than the amount of the note itself; or one of the indorsers may have a claim against his indorsee. All these claims, counterclaims and offsets of prior parties against one another are of no concern to a holder in due course. He may say, in effect, "This instrument which I hold provides on its face for payment of a certain sum, by a certain person or persons, and at a certain time; and that is all that concerns me. I am not interested in the history of the instrument; in any personal defenses or disputes as between prior parties to the instrument; in any questions as to whether the instrument was originally given for an inadequate consideration, or for no consideration at all; or whether it was procured through fraud, duress, or without actual delivery. All these matters do not concern me. I am interested only in what I read within the four covers of the instrument. So far as I am concerned, the instrument is a 'courier without luggage, whose countenance is its passport.'"

310. No holder in due course of nonnegotiable instrument. Rights in a nonnegotiable instrument, like rights in any other contract, pass by assignment, subject to any defenses (sec. 206). Hence there can be no holder in due course of a nonnegotiable instrument.

311. No holder in due course of stale demand instruments. When an instrument payable on demand is negotiated an unreasonable length of time after its issue, the holder is not deemed a holder in due course. The Uniform Negotiable Instruments Act provides that in determining what is an unreasonable time, regard is to be had to the nature of the instrument, trade usage in connection therewith, and the facts of the particular case.

312. Acquiring rights of holder in due course without being one. A person may acquire the *rights* of a holder in due course without being one, provided he was not a party to any fraud or illegality affecting the instrument.

Example: You are a holder in due course of a note procured by the payee through fraud. Being a holder in due course, you were unaware of the fraud when you took the note. You indorse the note to me. I know of the fraud; hence I am not a holder in due course. But I acquire, by assignment, your right as holder in due course to collect the note regardless of the fraud, provided I had no part in the fraud.

Any other rule than the above would unjustly limit the marketability of an instrument in the hands of a holder in due course.

313. Note made in one state, payable in another. When a bill or note is executed in one state or country and payable in another, the general rule is that it is governed, as to its nature, validity, interpretation and effect, by the laws of the state where made payable, without regard to the place where it is written, signed or dated; it being presumed that the parties contracted with reference to the laws of that state.⁸ Hence if a note payable in New York is made in New Hampshire, mailed in Vermont to a New York payee, and negotiated by the latter in New Jersey, the New York law applies.

F. Liabilities of Parties

314. Parties liable. As previously stated (sec. 264), no person can be liable on a negotiable instrument unless his name is on it. All parties to an instrument are liable on it in some way. The nature and extent of such liability depends on the instrument itself (amount, date when due, whether with or without interest, and so on) and on the *capacity in which a party affixes his signature*. On a note, a party may affix his signature in the capacity of maker or indorser; on a bill, in the capacity of drawer, drawee-acceptor or indorser. In these capacities, a party's liability may be *primary* or *secondary*.

315. Primary and secondary liability. A party is *primarily* liable on an instrument if he is absolutely bound to pay it; that is, if he has to pay it in the first instance. All other parties are *secondarily* liable.

Parties primarily liable. The maker is primarily liable on a note, the acceptor (sec. 281) on a bill. They are the parties to whom the instrument must first be presented for payment. Their liability is absolute, not conditional.

Parties secondarily liable. The indorsers are secondarily liable on a note; the drawer and indorsers, on a bill. They are the parties who must pay the instrument if the party primarily liable does not. Their liability, therefore, is conditional.

316. Maker's liability. The maker of a note engages to pay it according to its terms. He admits (1) the existence of the payee and (2) his capacity then to indorse.

⁸ 8 *Corpus Juris* 92.

Example: For the use of a truck owned by John Beck and Tom Strange, I give them a note payable to "Beck & Strange," which is thus indorsed to Thomas for value. The Court would reject my refusal to pay the note based on the ground (1) that there was no such firm as "Beck & Strange," or (2) that they could not indorse in such capacity.

317. Acceptor's liability. The acceptor of a bill engages to pay it according to its terms, and admits:

(a) *As to the drawer:* (1) his existence, (2) the genuineness of his signature, and (3) his capacity and authority to draw the instrument.

(b) *As to the payee:* (1) his existence, and (2) his capacity then to indorse.

Examples:

(1) An acceptor may not refuse payment on the ground (a) that a drawer's name is fictitious or (b) forged or (c) that the drawer was insane, or had no authority to draw the draft—though all these statements be true.

(2) On a bill drawn in favor of the XYZ Corporation as payee, the acceptor may not refuse payment on the ground (a) that there is no such corporation or (b) that the bill was indorsed for such corporation by an unauthorized person.

But the acceptor does not admit the genuineness of any part of the draft except the drawer's signature. Thus, proof of a material alteration in the body of a bill furnishes a complete defense to the acceptor. If he has paid the bill in ignorance of the alteration, he may recover such payment from the party receiving it. If an acceptor pays a bill to a holder who has derived title through a forged indorsement, he may recover such payment from the holder upon discovering the forgery.

318. Conditions of secondary liability. The conditions of secondary liability are (1) those imposed by a party himself (for example, by an indorser in the way he indorses) and (2) those imposed by law, which must be complied with before the drawer or indorsers can be held (presentment, notice of dishonor, notice of protest, and so on).

As stated, the parties secondarily liable on a bill are the drawer and indorsers; on a note, the indorsers.

319. Drawer's liability. The drawer of a bill admits (1) the existence of the payee, and (2) his capacity then to indorse; and engages (1) that on due presentment (sec. 335) the instrument will be accepted, paid, or both, according to its terms, and (2) that if the instrument be dishonored (sec. 356) and necessary proceedings on dishonor taken (secs. 357-362), he

will pay the amount of it to the holder or any subsequent indorser compelled to pay it. (A drawer may insert a provision in an instrument disclaiming or limiting his liability to the holder.)

320. Indorser's liability: general *v.* qualified indorsers. From the standpoint of liability, all indorsers may be classed as (a) *general* or *unqualified*, and (b) *qualified*. Both classes of indorsers are liable on substantially similar warranties, but qualified indorsers do not undertake to pay on default of the party primarily liable.

321. Liability of general indorser. A general or unqualified indorser, whether his indorsement is in blank, special or full, restrictive, conditional or irregular (as an accommodation), warrants *four* things and undertakes *two*.

He warrants to all subsequent holders in due course:

(1) *That the instrument is genuine and in all respects what it purports to be* (for example, that the instrument is not forged or that a person signing it as an agent is duly authorized).

(2) *That he has a good title to it* and that all prior transferrors had good title.

(3) *That all prior parties had capacity to contract* (which would prevent the indorser from setting up as a defense against a subsequent holder in due course, that the maker of a note was an infant, lunatic or idiot).

(4) *That the instrument was valid and subsisting at the time he indorsed it.* (If, for example, a note is issued by a partnership or corporation for the accommodation of a third party, the indorser may not urge such fact in defense of his liability, because he has warranted the instrument to be valid and subsisting at the time of his indorsement.)

A general indorser further *undertakes*:

(a) That on due presentment (sec. 335) the instrument will be accepted, paid, or both.

(b) If not, and if the necessary proceedings on dishonor are taken (secs. 357-362), he will pay the instrument.

322. Liability of qualified indorser. A qualified indorser makes the same warranties as a general indorser except (4) above; and as to that, he merely warrants that *so far as he knows* the instrument is valid. Nor does he undertake that the instrument will be paid at maturity.

Thus, a person who indorses "without recourse" escapes liability on the instrument only (a) when the instrument is invalid and he had no knowledge of invalidity at the time of his

indorsement, or (b) where the instrument is valid but defaulted by the maker or acceptor.

Examples: Cook, who indorses the following six notes "without recourse," is liable to the holder, for the reasons indicated, on notes (1) to (5) inclusive, but not on note (6):

(1) A note on which the maker's signature is forged. (*Warranty that the instrument is genuine and what it purports to be.*)

(2) A note signed, "John Doe, by A. B., Attorney-in-fact," which John Doe never authorized. (*Warranty that the instrument is genuine and what it purports to be.*)

(3) A note payable to the order of Jones, as payee, indorsed by Jones in blank and stolen from him by Smith, who negotiated the instrument to Cook. (*Warranty of title.*)

(4) A note made by an infant. (*Warranty that all prior parties had capacity to contract.*)

(5) A note given by Atkins to Cook for a usurious consideration. (*Warranty that, so far as he knew, the instrument was valid. Cook knew the note was invalid.*)

(6) A note valid in all respects, defaulted by the maker at maturity. (*Cook did not undertake that the note would be paid at maturity.*)

323. Liability of indorser on nonnegotiable instrument. The term *indorsement* normally applies to negotiable paper only. Strictly speaking, there can be no indorsement of nonnegotiable paper, and the writing of one's name on such an instrument by way of transfer constitutes an assignment under the law of contracts. There is considerable conflict in the various jurisdictions as to the liability incurred by such assignment. In some jurisdictions, the liability is prescribed by statute. In others,⁹ the indorsement of itself creates no liability on the part of the indorser (assignor) to the assignee, but merely transfers the assignor's rights. In still other jurisdictions,¹⁰ the indorser is liable to the indorsee either as maker or as guarantor. In several states,¹¹ the indorser is liable only if by due diligence the note cannot be collected from the maker.

324. Liability of person negotiating by delivery. When one negotiates an instrument by delivery alone, without indorsement, his liabilities are the same as those of a *qualified indorser*, except that his warranties run in favor of no one but the person to whom he delivers the instrument.

⁹ Including Illinois, Pennsylvania and Montana.

¹⁰ Including Maryland, Massachusetts, New York, Vermont and Tennessee.

¹¹ Connecticut and Indiana.

Example: A gives B a note for \$100 payable to "B or bearer." The note is transferred several times by delivery only, and gets into the hands of R as a note for \$1000. R may hold A for \$100 only (according to the "original tenor" of the note), but he may hold his immediate transferor (whether the latter had anything to do with the alteration or not) for the other \$900, because one who negotiates an instrument by delivery only, warrants (to his immediate transferee) the genuineness of the instrument.

If a person indorses an instrument which is negotiable by delivery only, he incurs all the liabilities of an indorser.

Agent negotiating instrument without indorsement. When a broker or other agent negotiates an instrument without indorsement, he incurs all the liabilities of a qualified indorser unless he discloses the name of his principal and the fact that he is acting only as agent.

325. Order of liability among indorsers. In the absence of agreement, indorsers are liable to one another in the order of their indorsement. Thus, if the holder of a note, on the maker's default, elects to hold only the last of five indorsers instead of all five together, the last indorser may recover against the fourth, the fourth against the third, and so on. But where (as in *Empire Trust Co. v. Bartley & Co.*)¹² the indorsers of a note agreed among themselves that each would pay one third of the amount without recourse to the others, one indorser could recover against the other two after discharging more than one third of the note, since the indorsers by special agreement assumed among themselves the relationship of *cosureties* (sec. 933). Without such agreement they would have been liable in the order of their indorsement.¹³

326. Striking out indorsement. The holder may at any time strike out any indorsement not necessary to his title. The indorser whose name is thus stricken out, and all indorsers subsequent to him are thereby relieved from liability on the instrument.

Example: If F, the holder of a note indorsed by B, C, D and E, strikes out C's indorsement, he releases not only C, but D and E as well.

327. Instrument negotiated back to indorser. When an instrument is negotiated back to a prior party, he may reissue and renegotiate it. But he is not entitled to enforce payment of the instrument against any intervening party to whom he was personally liable. (For an example, see sec. 1470.)

¹² 258 App. Div. 249, 16 N.Y. Supp. 2d 248.

¹³ *Ray v. Livingston*, 204 N.C. 1, 167 S.E. 496; *Harris v. Jones*, 23 N.D. 488, 136 N.W. 1080; *Whitten v. Kroeger*, 183 Okl. 327, 82 P. 2d 668.

328. Liability of accommodation party. An accommodation party is one who signs an instrument as maker, drawer, acceptor or indorser, without receiving value therefor, and for the purpose of lending his name to some other person. Accommodation paper is any type of bill or note to which an accommodation party puts his name.

When a person, not otherwise a party to an instrument, places his signature thereon in blank before delivery, he is liable as indorser in accordance with the following rules:

(a) If the instrument is payable to the order of a third person, he is liable to the payee and to all subsequent parties.

(b) If the instrument is payable to the order of the maker or drawer or is payable to bearer, he is liable to all parties subsequent to the maker or drawer.

(c) If he signs for the accommodation of the payee, he is liable to all parties subsequent to the payee.

An accommodation party, of course, is not liable to the party accommodated.

Knowledge by holder. An accommodation party is liable to a holder for value even if the latter, when he took the instrument, knew the former to be an accommodation party (sec. 1474).

Absence of consideration immaterial: wives as accommodation parties. The very nature of an accommodation signature denotes absence of consideration. Such absence is therefore no defense to liability where a married woman, without consideration, adds her signature to her husband's on a note, except when she is exempted by statute (see sec. 138).

Example: A farmer, owing money for feed, gives, in payment, a note signed by himself and his wife. In a suit on the note, the wife could not escape liability on the ground that her signature was gratuitous and that the holder knew it (except in states where married women are exempt by statute from suretyship or accommodation liability).

Alterations in liability of accommodation party. An accommodation indorser, like a surety, is discharged if his risk is altered without his consent.

Examples:

(1) Following an accommodation indorsement, a collateral agreement is entered into between maker and holder (but without the accommodation indorser's knowledge or consent), which provides that if any one of a series of notes is defaulted, all become due. Such an agreement varies the accommodation indorser's liability and therefore discharges him (sec. 1472).

(2) If one of two accommodation parties is released without the other's consent, the latter is discharged.

(3) If the holder, by renewal note or otherwise, gives the maker a valid extension of time in which to pay the note, without an accommodation party's consent thereto, the latter is discharged, unless the holder reserves

his rights against the accommodation party, in which event the latter may promptly pay and then bring immediate suit against the maker for reimbursement (sec. 927).

Accommodation paper transferred after maturity. Ordinarily, one who takes an instrument after it is overdue is not a holder in due course and is subject to all defenses which may be urged against an ordinary assignee, unless he acquired the instrument from a holder in due course (sec. 312). This rule likewise applies to persons taking accommodation paper after maturity, so that an accommodation party may urge absence of consideration against such transferee, unless the latter acquired the instrument from a holder in due course. The rule is the same where the *party accommodated* transfers the instrument after maturity, but in such cases a minority of states¹⁴ have held that such transferee may not hold the accommodation party if he knew him to be such when he took the instrument.

Rights of accommodation party. When an accommodation party pays the instrument, he may proceed against the party accommodated and all parties prior to him, for recovery of the amount paid.

329. Partnership and accommodation paper. A partner has no right to execute accommodation paper in the name of the firm. Where the accommodation character of such paper is obvious, or where the person to whom the note is given knows or ought to know from the circumstances that the instrument is not given for partnership purposes, he cannot hold copartners on such instrument without their previous acquiescence, subsequent ratification, or estoppel.

330. Corporations and accommodation paper. A corporation has no power to execute or indorse accommodation paper. A corporation may, however, be estopped (sec. 103) from contending that it had no such power, where it has made a practice of issuing and later honoring such paper.¹⁵

331. Liability on negotiable document of title. When a person, by indorsement and delivery, negotiates a document of title, such as a warehouse receipt or a bill of lading, he warrants:

- (a) That the receipt or bill of lading is genuine.
- (b) That he has a legal right to negotiate it.
- (c) That he knows of no fact which would impair the validity or worth of the document.
- (d) That he has a right to transfer title to the goods.
- (e) That the goods are merchantable or fit for a particular purpose (whenever such warranties would be implied without receipt or bill).

¹⁴ Including Alabama, Connecticut, Illinois, Maine and Maryland.

¹⁵ *Jacobus v. Jackson*, 211 N.Y. 154.

G. Defenses

332. In general. If there is any reason why a party is excused from liability on an instrument, he is said to have a *defense* to it. Under this head we consider defenses available to parties primarily liable. Such defenses may not be available to parties secondarily liable. For example, forgery, infancy or insanity would constitute a defense by a maker (who is primarily liable) against even a holder in due course; but an indorser would be liable in such case on his warranties of genuineness and capacity of prior parties (sec. 321). Defenses available to parties secondarily liable are considered in connection with presentment, dishonor and protest (secs. 335-362).

Defenses available to parties primarily liable are either *personal* ("nominal") or *real* ("absolute").

333. Personal ("nominal") defenses. Personal defenses to a negotiable instrument are those which are personal to the original parties or their assignees but which are cut off and become unavailable against a holder in due course. In other words, the payee and all subsequent holders except holders in due course are subject to such defenses. These defenses are:

(a) *Lack of consideration.* Allen, without consideration, gives Baker a note. Allen could successfully resist payment against Baker or any subsequent holder except a holder in due course.

(b) *Failure of consideration.* Baker sells Allen a secondhand machine with a sixty-day guaranty, for which Allen gives his ninety-day note. The machine proves worthless after a ten-day trial. Allen may resist payment of his note as against Baker or any subsequent holder except a holder in due course.

(c) *Breach of contract.* Allen gives Baker a thirty-day note for which Baker, a mason, agrees to erect a retaining wall. Baker defaults. Neither Baker nor any subsequent holder except a holder in due course may compel Allen to pay the note.

(d) *Counterclaim or setoff.* Baker agrees to ship 500 Swiss watches to Allen at \$20 per watch, for which Allen gives Baker his note for \$10,000. When the shipment arrives, it is found to be fifty watches short. Upon suit on the note, Allen may successfully interpose a setoff for \$1000 against Baker or any subsequent holder except a holder in due course.

(e) *Fraud (in the inducement).* Baker, after tampering with the speedometer, sells a secondhand automobile to Allen upon the fraudulent representation that the car has gone only 10,000 miles. Allen gives his note for the car. Upon discovering the facts, Allen may resist payment of the note as against Baker or any subsequent holder except a holder in due course.

But where an instrument is issued through the fraud of a third party, *not the payee*, and the payee, without notice of the fraud, gives value for the instrument, he or any subsequent holder not a party to the fraud may enforce payment of the instrument.¹⁶

Example: X, purporting to represent a charity, gets Y to draw a check for \$100 to the order of A, then cashes the check with A, who knows nothing of X's fraud. X disappears. A deposits the check, but Y, having discovered the fraud, stops payment. In a suit on the check by A, Y's defense of X's fraud will be unavailing.

(f) *Duress.* If Baker obtains a note from Allen by threatening to expose Allen's wife as a shoplifter, neither Baker nor any subsequent holder except a holder in due course can compel Allen to pay the note.

(g) *Blank spaces wrongly filled in.* As previously noted (sec. 291), when an instrument is wanting in any material particular, the person in possession of it is presumed to have authority to complete it by filling in the blanks. If he disobeys instructions and fills the blanks in wrongly, such fact will constitute a defense against the payee or any subsequent holder, except a holder in due course.

(h) *Nondelivery (of complete instrument).* As noted in section 292, unless a person has issued (hence delivered) an instrument, or caused it to be delivered, he is not liable on it; except that if the instrument is complete in form and gets into the hands of a holder in due course, delivery as to such holder will be conclusively presumed.

(i) *Payment.* Allen gives Baker his thirty-day note for \$100 for a loan in that amount. Ten days later, Allen pays Baker the full amount of the loan but fails to pick up the note. Neither Baker nor any subsequent holder except a holder in due course can force Allen to pay the note again.

334. Absolute ("real") defenses. Absolute or real defenses are such as can be urged against *any* holder of a negotiable instrument, including a holder in due course. These defenses are:

(A) *Forgery.* The Negotiable Instruments Act provides that when a signature is forged, or made without the authority of the person whose signature it purports to be, it is wholly inoperative. No right to retain the instrument, or to give a discharge for it, or to enforce payment against any party to it, can be acquired through such a signature, unless the party against whom it is sought to enforce the instrument is estopped from urging the defense of forgery or want of authority.

Example: Swift, Jr., without authority, signs his father's name to a check payable to the order of Bates, who negotiates it to Clyde. Though Clyde were ignorant of the forgery and gave value for the check, he could not

¹⁶ *Farmer's Sav. Bank of Ruthven v. Grange*, 199 Iowa 978, 203 N.W. 37; *Cook v. Parker* (Cal. App.), 71 P. 2d 591; *Williams v. Garrett*, 32 Ga. App. 762, 124 S.E. 811; *Utah State Nat. Bank v. Stringer*, 44 Idaho 599, 258 P. 522; *Kansas City Wholesale Grocery Co. v. Ridgeway*, 115 Kan. 685, 224 P. 38.

compel Swift, Sr. to pay it, because one is not liable on an instrument he did not make. But if Clyde had sought to verify the signature and Swift, Sr. (to protect his son) had assured Clyde that the signature was genuine, Swift, Sr. would be estopped from later urging forgery or want of authority as a defense.

(1) *Forged indorsements: in general.* No title to a bill or note passes by a forged indorsement. Hence the payee of a check whose signature has been forged may (in the absence of negligence or estoppel) recover the amount of the check (a) from the drawer, or (b) from an indorsee (*bona fide* or otherwise) to whom the check was paid by the drawee bank, or (c) from the drawee bank which paid the check to anyone claiming under the forged indorsement.¹⁷

(2) *Forged indorsements: fictitious or nonexistent payee.* Under the Negotiable Instruments Act, where a bill or note is payable to the order of a fictitious or nonexistent person and *such fact is known to the person making it so payable*, the instrument is payable to bearer. But if an impostor gets someone to make or draw an instrument in favor of a fictitious payee and then, impersonating such payee, indorses and cashes the instrument, the maker or drawer is not liable because he had no knowledge that the payee was fictitious, hence no intention that the instrument was to be deemed payable to bearer.

Example: An impostor, purporting to represent "Lieut. Parks" as the alleged head of a tuberculosis camp, obtained from American Raw Silk Co. a check made out to the order of "Lieut. Parks," and then cashed the check with United Cigar Stores Co., after indorsing it, "Lieut. Parks." United Cigar Stores Co. was ignorant of any wrongdoing. American Raw Silk Co., upon ascertaining that both "Lieut. Parks" and the camp were nonexistent, stopped payment of the check. In a suit by United Cigar Stores Co. against American Raw Silk Co., the Court held for American Raw Silk Co.: Only where the maker or drawer *knows* that the payee is fictitious may an instrument payable to a fictitious payee be treated as payable to bearer. "This check, intended to be paid to Lieut. R. F. Parks, in charge of a tuberculosis fund for the Navy, has never been indorsed by Parks, or anyone assuming to be Parks, in any of these negotiations . . . judgment directed in favor of defendant, dismissing the complaint with costs."¹⁸

(3) *Indorsement by impostor v. indorsement by thief or swindler.* When an instrument is delivered to an impostor who pretends to be someone else and the impostor indorses the check in the name of the payee and cashes it, the transaction constitutes a fraud, but the impostor's indorsement is not a forgery, because the person who indorsed the instrument was the same person who (mistakenly) was made the payee. Consequently, as between the drawer and the bank, the loss falls on the drawer. (See sec. 386.)

Where, however, a properly drawn and legally valid check is in the hands of the payee, and a thief or swindler gets hold of it and cashes it by indors-

¹⁷ 10 *Corpus Juris Secundum* 1088-1089.

¹⁸ *United Cigar Stores Co. v. American Raw Silk Co.*, 184 App. Div. 217, aff'd 229 N.Y. 532.

ing the payee's name, no rights can arise by such indorsement, since it is a forgery. If the drawer's account has been charged, he may compel the bank to restore the credit. The payee, however, may not compel the bank to pay him the amount of the check, since a bank is under no contractual duty to him (sec. 376); but the payee may compel the bank to return the check, and he may then present the check for payment. If the bank dishonors the instrument by refusing to pay it, the payee may hold the drawer (sec. 376).

(B) *Material alteration.* Any alteration is material which changes the date, the sum payable, the time or place of payment, the number or relation of the parties, or the medium of payment, or which adds a place of payment where none is specified, or alters the effect of the instrument in any respect. Material alteration of an instrument without the assent of all parties liable thereon voids the instrument except as against a party who makes, authorizes or assents to the alteration, and except as against subsequent indorsers (who, by indorsing, warrant the regularity and genuineness of the instrument). However, though even a holder in due course may not enforce such alteration against the maker or drawer who did not authorize or assent to it, he may enforce the instrument "according to its original tenor" (that is, as it was before the alteration). For an illustration, see section 1481, subd. a.

(1) *Alteration v. filling in blank spaces.* To alter an instrument is to change something already in it. This is very different from the act of wrongly filling in a blank space. As previously noted (secs 290-291), where a missing date is supplied or other blank space filled in contrary to instructions, the maker or drawer may become liable on such instrument, changes and all, to a holder in due course.

(2) *Negligence inviting alteration.* The early English rule, that a person is liable on an altered instrument where he has executed it so negligently "that it can readily be altered without giving it an appearance calculated to excite the suspicion of a prudent man," is by no means the uniform rule in this country. Some states hold that the maker or drawer is liable (to a holder in due course) only where a party wrongly filled in blanks that are so obvious as to suggest that the filling in was impliedly authorized. Other states hold that a person owes no duty to guard against a crime. It is probable that most courts would agree that if blank spaces are so negligently left as to invite alteration and to justify belief that the filling in was regular and authorized, a holder in due course could collect an instrument so altered. (See sec. 388.)

(3) *Immaterial alteration accompanied by filling in.* Where an immaterial alteration is accompanied by the unauthorized filling in of a blank space, the drawer or maker is liable (to a holder in due course) notwithstanding.

Example: Foster signs and delivers to his secretary, a salary check with the amount (in words) blank, and the marginal amount (in figures) filled in as \$50. The secretary writes "Five Hundred Dollars" in the blank space, raises the figures to \$500, cashes the check at the bank, and disappears. As between Foster and the bank, Foster is liable. The marginal figures on an

instrument are not a part of the instrument but are regarded as "merely a memorandum for convenience."¹⁹ Hence the alteration was immaterial, and the filling in of the blank space (as to the bank, which was a holder in due course) was impliedly authorized.

(4) *Alteration of stock certificate.* The rules governing alteration of negotiable instruments are not applicable to certificates of stock. Although a *bona fide* purchaser of a lost or stolen stock certificate *indorsed in blank* gets good title under the Uniform Stock Transfer Act (sec. 286), this rule does not apply where theft and forgery intervene between the true owner and a *bona fide* purchaser.

Example: A certificate of stock issued to Lovett & Co. is indorsed by them in blank and sold to Whitestone & Co. A thief steals the certificate, erases the name Lovett & Co., also the indorsement, substitutes the name Adolph Zitman as stockholder, and indorses in that name to Brown & Co., an innocent pledgee. As between Whitestone & Co. and Brown & Co., the former will succeed in establishing the right to the stock.²⁰

(C) *Incompetence (contractual incapacity).* Incapacity to contract, such as that arising out of infancy or insanity, is a real defense, good against a holder in due course.

(D) *Illegality.* Mere illegality is no defense against a holder in due course. For example, it is illegal in many states for a corporation selling original issue stock to take a note in payment, or anything else except money, property, or services; yet the maker of such a note cannot urge such illegality as a defense against a holder in due course. But where a statute specifically declares a given type of transaction, or instrument given for it, *void*, such fact is a real defense, good even against a holder in due course. Examples:

(1) *Gambling transactions.* Some states expressly make gambling transactions, including instruments given in connection therewith, void; others do not. In the former, the fact that the instrument was given for a gambling debt is a real defense, good against a holder in due course; in the latter states, this would not be true. In any event, if an instrument has a valid inception, the fact that it was later negotiated in payment of a gambling debt would furnish no defense to payment.

Examples:

(1) Green gives White a check for \$30 in payment of a poker debt. White gives the check to his landlord for rent. Green in the meantime stops payment of the check, and the landlord sues him. Judgment for Green. The check was void at its inception.²¹

(2) If the check had been given originally by Green to his landlord for rent and the landlord had given the check to White in payment of a poker debt, such fact would have furnished no defense to Green in an action on the check by White.

¹⁹ *Vinson v. Palmer*, 45 Fla., 630, 636.

²⁰ *National Surety Co. v. Indemnity Co. of North America*, 237 App. Div. 485.

²¹ *Larschen v. Lantzes*, 115 Misc. 616.

(2) *Sunday instruments.* In states which have statutes declaring Sunday business transactions void, instruments given on Sunday in connection with such transactions are likewise void, provided the fact of Sunday issuance is apparent on the face of the instrument. But if an instrument, though given on Sunday, is dated as of a weekday, the person so dating it is estopped, as to a holder in due course, from setting up as a defense the fact that it was actually issued on a Sunday.

(3) *Usury.* Some statutes merely render usury illegal and provide penalties for it. Most states, however, declare usurious transactions, and instruments given in connection with them, void at their inception. In the former states, usury is no defense against a holder in due course. In the latter, a holder in due course is subject to the defense of usury, on the principle that otherwise it would be easy to defeat the statute by transferring the instrument to an actual or pretended holder in due course.

(E) *Fraud (in the execution).* When one's signature is procured by trickery, without actual intent by the signer to make or draw a negotiable instrument, no liability arises, even to an innocent holder for value.

Examples:

(1) A printed receipt is presented to Brown for signature, and while Brown is adjusting his spectacles, a promissory note is substituted instead.

(2) White scribbles his name on a blank sheet of paper, and Black, without White's knowledge, fills in a negotiable instrument over the signature (sec. 293).

(F) *Nondelivery (of incomplete instrument).* Although delivery of a complete instrument is conclusively presumed (sec. 292), this is not true of an incomplete instrument. Nondelivery of such an instrument is a real defense. (See sec. 293.)

H. Presentment

335. Presentment: definition and types. An instrument is *presented* when it is placed before a person obligated or to become obligated on it with the request that he honor the obligation.

Presentment may be for acceptance and for payment.

336. Presentment for acceptance. Presentment for acceptance relates only to bills of exchange (drafts). If I draw a draft on you as drawee, that does not make you liable on the instrument. I must first *present* the draft to you for *acceptance*. If you accept, the instrument is *honored*. If you refuse or neglect to accept, the instrument is *dishonored by non-acceptance*.

337. Bills which must be presented for acceptance. Presentment for acceptance is not necessary, and a drawee may pay a draft when due without prior presentment for acceptance, except in the following cases:

(a) Bills payable "after sight": If a bill is payable 30 days after sight, it cannot mature until it has been "seen," and accepted;

(b) Bills expressly stipulating that presentment for acceptance be made; and

(c) Bills payable elsewhere than at the drawee's residence or place of business.

338. Presentment for acceptance: time and manner of making.

When presentment for acceptance is necessary, the holder must make it within a reasonable time after issuance, and in any event before it is overdue, or the parties secondarily liable (drawer and indorsers) are discharged.

Bills may be presented for acceptance at a reasonable hour on any business day, and up to twelve o'clock noon on Saturdays (except when Saturday falls on a legal holiday).

The bill must be presented to the drawee or some person authorized to accept or refuse acceptance on his behalf.

In a partnership, presentment may be made to any partner. In other situations, the following rules govern:

(a) When a bill is addressed to two or more drawees, not partners, presentment must be made to them all, or to any one having authority to accept for all.

(b) When the drawee is dead, presentment may be made to his personal representative (sec. 1177).

(c) When the drawee has been adjudged a bankrupt or is insolvent, or has made an assignment for the benefit of creditors, presentment may be made to him or to his trustee or assignee.

339. Presentment for acceptance: when excused. Presentment for acceptance is excused and a bill may be treated as dishonored by nonacceptance:

(a) When the drawee is dead or has absconded or is a fictitious person or a person not having capacity to contract by bill.

(b) When after the exercise of reasonable diligence, presentment cannot be made.

(c) When, although presentment has been irregular, acceptance has been refused on some other ground.

340. Acceptance: how made. The Negotiable Instruments Act provides that the drawee must accept in writing, and on the face of the bill, if the holder requires it; otherwise the holder may treat the bill as dishonored. It is customary for the drawee to accept by writing "Accepted" across the face of the bill followed by date and signature.

Under certain circumstances, however, which are referred to

in the following section, the drawee may be deemed to have accepted without a writing.

341. Time allowed drawee to accept: effect of retention, destruction or refusal to return bill. There is a conflict of authority on whether or not a drawee's mere retention of the bill beyond the period allowed for acceptance constitutes an acceptance. The weight of authority is that it does not; the circumstances must show an intention to accept. The Uniform Negotiable Instruments Law provides²² that where a drawee destroys the bill or refuses within twenty-four hours after presentment, or within such other period as the holder may allow, to return the bill to the holder, accepted or not accepted, he will be deemed to have accepted the bill. The court has held, however, that this relates to the affirmative act of destruction or refusal, not to the negative act of failing to return the instrument.²³ The Uniform Act²⁴ provides further that where a bill is duly presented for acceptance and is not accepted within the prescribed time, the person presenting it must treat the bill as dishonored by nonacceptance, or he loses the right of recourse against the drawer and indorsers.

342. Promise to accept. An unconditional promise in writing to accept a bill before it is drawn is deemed an actual acceptance in favor of every person who, on the faith of such promise, receives the bill for value. The bill must be drawn, however, strictly in accordance with the terms of the promise to accept. Immaterial variations may be ignored.

Example: A bank agreed to pay a check for \$1035. The check as written called for \$1035 "with exchange." Held, the acceptance was valid, since the variation was immaterial; the bank was not liable to pay exchange on the check drawn on it and payable over its counter.²⁵

343. Who may accept bills. Only the drawee may accept. There are, however, two exceptions to this rule. These relate

²² Section 137.

²³ *Matteson v. Moulton*, 79 N.Y. 627. "In the absence of statutory provisions changing the rule, the weight of authority favors the position that mere retention alone will not bind the drawee as acceptor." 10 *Corpus Juris Secundum* 664, citing *Hibbard v. Parciak*, 94 Conn. 562, 109 A. 725; *Southern Creosoting Co. v. Chicago & A.R. Co.* (Mo.), 205 S.W. 716; *Mitchell Livestock Auction Co. v. Bryant State Bank* (S.D.), 275 N.W. 262.

²⁴ Section 150.

²⁵ *Iowa State Sav. Bank of Fairfield v. City Nat. Bank of Tipton*, 133 Iowa 1347, 168 N.W. 148.

to referees in case of need, and acceptances "*supra protest*" for honor.

344. Referee in case of need. A "referee in case of need" is a person named in a bill to whom presentment may be made in case the instrument is dishonored by nonacceptance or nonpayment. The holder may or may not resort to such person, at his option.

345. Acceptance for honor "*supra protest*." If a bill has been dishonored by nonacceptance *and is not yet overdue*, it may be accepted (with the holder's consent) by any person not already a party to the instrument, for the honor of a person liable on it or for whose account the bill is drawn.

How executed. An acceptance for honor must be in writing, signed by the acceptor for honor, and it must indicate that it is such an acceptance.

Liability. The acceptor for honor is liable to the holder and all parties subsequent to the party for whose honor the bill has been accepted, on the following engagement: that he will pay the bill according to the terms of his acceptance provided (1) the drawee has not paid it, and (2) the bill has been presented for payment and protested for nonpayment, and due notice of dishonor has been given to the acceptor for honor.

346. Presentment for payment: in general. Presentment for payment relates to both bills and notes. An instrument is presented for payment to the person primarily liable on it: maker of note, acceptor of bill. If such person is absent or inaccessible, presentment may be made to any person found on the premises. The instrument must be exhibited to the person from whom payment is demanded, and when it is paid, it must be delivered up to the party paying it.

Presentment for payment is necessary if the parties secondarily liable are to be held.

Example: An audit of Brown's books shows a past due note for \$10,000 made by Wilson and indorsed by James. Wilson is wholly bankrupt. James is a wealthy man. The note was never presented for payment. What is the note worth? Nothing. James is discharged by Brown's failure to make presentment.

But failure to make presentment for payment does not discharge the party *primarily* liable, because he is absolutely liable in any event. He merely need not pay interest accruing after maturity if he was ready, willing and able to pay at the proper time and place.

Accommodation maker primarily liable. An accommodation maker, though known to be such to the holder, is, as to the latter, primarily lia-

ble; hence he remains liable notwithstanding nonpresentment. (See section 1450, subd. (c).)

347. Presentment for payment: time. All instruments not payable on demand must be presented for payment on due date. If due date falls on a Saturday, Sunday or legal holiday, presentment must be made on the next succeeding business day. If Friday is a legal holiday and an instrument falls due on that day, the following Monday is regarded as the next succeeding business day.

When an instrument is payable a given number of days after date or after sight or after the happening of a specified event, the date of payment is determined by excluding the day or event from which the time is to run and by including the day of payment.

Demand instruments must be presented for payment *within a reasonable time after issue*, except that a demand bill may be presented for payment *within a reasonable time after its last negotiation*. The Negotiable Instruments Act provides that in determining what is a "reasonable time" or an "unreasonable time," regard is to be had to the nature of the instrument, the usage of trade or business (if any) with respect to such instruments, and the facts of the particular case. Court decisions throughout the country have varied widely as to reasonable and unreasonable periods.

Examples:

(1) Delays in presenting sight bills or drafts of four days (Mass.), six days (Mich.), seven days (Pa.), eleven days (Pa.), one month (N.Y.), thirty-five days (Ill.), seven weeks (Tex.), two months (N.Y.), and three months (La.) have been held not unreasonable in view of given circumstances; but delays of five days (Ky.), ten days (N.Y.), sixteen days (W.Va.), twenty-one days (Mich.), one month (N.C.), more than one month (U.S.), one year or more (U.S.), two years (La.) and two and one-half years (Tex.) were declared unreasonable in view of other circumstances.

(2) Delays in presenting notes for periods ranging from four days to nine and one-half years have been held not unreasonable under given circumstances, though similar ranges of delay under other conditions were held unreasonable.

Demand instruments presented on Saturday. An instrument payable on demand may be presented for payment on a Saturday up to twelve o'clock noon (unless the entire day is a legal holiday).

Proper hours. An instrument payable at a place of business must be presented during the usual business hours; at a person's home, before the usual hours of rest.

348. Presentment for payment: place. Presentment for payment is made at the proper place:

(a) When a place of payment is specified in the instrument and it is there presented.

(b) When no place of payment is specified but the address of the person to make payment is given in the instrument and it is there presented.

(c) When no place of payment is specified and no address is given and the instrument is presented at the usual place of business or residence of the person to make payment.

(d) In any other case if presented to the person to make payment wherever he can be found or if presented at his last known place of business or residence.

349. Presentment for payment when instrument payable at bank. Making an instrument payable at a bank is equivalent to an order to the bank to pay it for the account of the person primarily liable on it. However, presentment for payment must be made during banking hours unless the person to make payment has no funds there to meet it at any time during the day, in which case presentment at any hour before the bank is closed on that day, is sufficient. (See sec. 1484.)

350. Presentment for payment where principal debtor is dead. Where the person primarily liable on the instrument is dead and no place of payment is specified, presentment for payment must be made to his personal representative (sec. 1177) if such there be, and if with the exercise of reasonable diligence he can be found.

351. Presentment for payment where several persons are primarily liable. Where several persons are primarily liable on an instrument and no place of payment is specified, presentment may be made to any one of them if they are partners; otherwise, it must be made to all.

352. When presentment for payment is not required to charge the drawer. Presentment for payment is not required to charge the drawer when he has no right to expect or require that the drawee or acceptor will pay the instrument.

353. When presentment for payment is not required to charge the indorser. Presentment for payment is not required to charge an indorser when the instrument has been made or accepted for his accommodation and he has no reason to expect that the instrument will be paid if presented.

354. When presentment for payment may be dispensed with. Presentment for payment is dispensed with:

(a) If with the exercise of reasonable diligence, presentment cannot be made.

(b) When the drawee is a fictitious person.

(c) By waiver of presentment, express or implied (sec. 370).

355. When delay in making presentment for payment is excused. Delay in making presentment for payment is excused when it is caused by circumstances beyond the control of the holder and not due to his own fault. When the cause of delay ceases to operate, presentment must be made with reasonable diligence.

I. Dishonor and Protest

356. Dishonor and protest, defined and distinguished. *Dishonor* consists in nonacceptance of a bill, or nonpayment of a bill or note. Protest is a formal attestation of dishonor. The word is often loosely used to mean taking the necessary steps to charge secondary parties (drawers and indorsers) with liability in case an instrument has been dishonored. Technically, however, a certificate of protest is a formal statement by a notary public, attested by his seal, or by a respectable resident of the place of dishonor in the presence of two or more witnesses, to the effect that presentment of a specific instrument was duly made at a given time and place to a given person, and payment or acceptance demanded and refused. *Notice of protest* is notice given by a notary to parties secondarily liable, of the fact that the instrument in question was duly presented, dishonored and protested.

When protest necessary. Only foreign bills of exchange (sec. 281), including checks, need be protested, though other instruments are often protested as a matter of business practice. Proof of presentment and dishonor is sometimes difficult when an instrument is drawn and payable in different states. Protest facilitates proof, because certificates of protest under the seal of a notary are commonly made "self proving" by statute.

357. Notice of dishonor; nature and purpose. *Notice of dishonor* is notice given orally²⁶ or in writing, personally, by mail,

²⁶ *O'Neal v. Clark*, 229 Ala. 127, 155 So. 562, 94 A.L.R. 589; *Caine v. Foreman*, 106 Cal. App. 636, 289 P. 929; *Blue Ribbon Garage v. Baldwin*, 91 Conn. 674, 101 A. 83; *Winn v. Perryman*, La. App. 160 So. 804; *McShane v. Dingley*, 132 Me. 429, 172 A. 264; *Harr v. Edsall*, 121 Pa. Super 19, 183 A. 67; *Carroll v. Fidelity Trust Co.*, 6 Tenn. Civ. App. 101; *Hall v. First State Bank of Hawley*, Tex. Civ. App., 4 S.W. 2d 253; *Harris v. Citizens Bank & Trust Co.*, 172 Va. 111, 200 S.E. 652; *Lawhead v. Nelson*, 113 W.Va. 453, 168 S.E. 659.

by wire, or even by telephone²⁷ to all parties secondarily liable, identifying the instrument and advising that it has been dishonored. By giving notice of dishonor, the holder perfects his rights against the parties secondarily liable; by failing to give it, he discharges them, and his only recourse then is against the party primarily liable.

358. Parties benefited by notice of dishonor. Where notice is given by or on behalf of the holder, it inures to the benefit of all subsequent holders and all prior parties who have a right of recourse against the party to whom it is given. Where notice is given by or on behalf of a party entitled to give notice, it inures to the benefit of the holder and all parties subsequent to the party entitled to give notice.

359. Notice of dishonor: to whom given. Except when notice of dishonor is waived or dispensed with, it must be given to the drawer of a bill and to each indorser of a bill or note.

Death. When any party is dead, and his death is known to the party giving notice, the notice must be given to a personal representative (sec. 1177), if there be one and if with reasonable diligence he can be found. If there is no personal representative, notice may be sent to the last residence or last place of business of the deceased.

Bankruptcy, and so on. Where a party has been adjudged a bankrupt or an insolvent or has made an assignment for the benefit of creditors (sec. 1295), notice may be given either to the party himself or to his trustee or assignee.

Partners and joint parties. When the parties to be notified are partners, notice to any one partner is notice to the firm even though there has been a dissolution. (See sec. 1486, subd. a.)

Notice to joint parties who are not partners must be given to each of them, unless one has authority to receive notice for the others.

Accommodation parties. An accommodation maker, as pointed out in section 346, is deemed primarily liable; hence he is not entitled to notice of dishonor. An accommodation indorser, however, is entitled to notice of dishonor.

360. Form and contents of notice. A notice of dishonor need not be in any particular form, so long as it conveys the following information: (a) description of instrument, (b) the fact of presentment and demand, (c) the fact of dishonor and (d) intent to look to the party secondarily liable for payment.

361. Time for giving notice of dishonor. The time for giving

²⁷ *Yonkers Nat. Bank v. Yerks & Co., Inc.*, 142 Misc. 640, aff'd 234 App. Div. 885.

ing notice of dishonor depends on whether parties reside in the same or different communities, as follows:

Where the parties reside in the same community:

(1) If given at the recipient's place of business: It must be *received* before the close of business on the *day after* dishonor.

(2) If given at the recipient's residence: It must be *received* before the usual hours of rest not later than the *day after* dishonor.

(3) If sent by mail: It must be mailed so as to *reach* the recipient in "usual course" on the *day after* dishonor.

Where the parties reside in different communities:

(1) If mailed: It must be deposited so as to go by mail not later than the *day after* dishonor.

(2) If given otherwise: It must be received within the same time as if mailed on the day after dishonor.

362. Successive notices. Each indorser, after receiving notice of dishonor, has the same time to give notice to prior parties that the holder has after dishonor. Thus, when a note held by *X* is indorsed by *A*, *B*, *C* and *D* in that order, and when *X* serves notice of dishonor on *D* only, *D* has the same time to serve notice on *C* (if he elects to notify *C* only) that *X* had to notify *D*; *C* would have the same time to notify *B* that *D* had to notify *C*, and so on.

363. Delay in giving notice: when excused. Delay in giving notice of dishonor is excused when the delay is caused by circumstances beyond the control of the holder and not imputable to his default, misconduct, or negligence. When the cause of delay ceases to operate, notice must be given with reasonable diligence.

364. Place for giving notice of dishonor. When a party has added an address to his signature, notice of dishonor must be sent to that address; but if he has not given such address, then the notice must be sent as follows:

(a) Either to the post office where he is accustomed to receive his letters; or

(b) If he lives in one place, and has his place of business in another, notice may be sent to either place; or

(c) If he is sojourning elsewhere, notice may be sent to him there.

But when the notice is actually received within the time specified in section 361, it will be sufficient, though not sent in accordance with the above requirements.

365. Notice by mail: presumption of delivery. When notice of dishonor is duly addressed and deposited in the post office, the sender is deemed to have given due notice, notwithstanding any miscarriage in the mails. Notice is deemed to have been deposited in the post office when deposited in any branch post office or in any letter box under the control of the post office department.

366. When notice is dispensed with. Notice of dishonor is dispensed with when, after the exercise of reasonable diligence, it cannot be given to or does not reach the parties sought to be charged. What constitutes reasonable diligence would be a question of fact in each case. For an example, see section 1487.

367. When notice to drawer is not required. Notice to the drawer is not required in any of the following cases:

- (a) When the drawer and drawee are the same person.
- (b) When the drawee is a fictitious person or a person not having capacity to contract.
- (c) When the drawer is the person to whom the instrument is presented for payment.
- (d) When the drawer has no right to expect or require that the drawee or acceptor will honor the instrument.
- (e) When the drawer has countermanded payment.

368. When notice to indorser is not required. Notice to an indorser is not required in any of the following cases:

- (a) When the drawee is a fictitious person or a person not having capacity to contract, and the indorser was aware of the fact at the time he indorsed the instrument.
- (b) When the indorser is the person to whom the instrument is presented for payment.
- (c) When the instrument was made or accepted for his accommodation.

369. Nonpayment following nonacceptance. Where due notice of dishonor by nonacceptance has been given, notice of a subsequent dishonor by nonpayment is not necessary, unless in the meantime the instrument has been accepted.

370. Waiver of protest. A waiver of protest, whether in the case of a foreign bill of exchange or other negotiable instrument, is deemed to be a waiver not only of a formal protest, but also of presentment and notice of dishonor. Waivers of

protest are frequently insisted upon by businessmen to dispense with the necessity, in case of suit, of proving presentment and notice of dishonor.

Notice of dishonor may be waived, either before the time of giving notice has arrived or after the omission to give due notice. The waiver may be express or implied. Express waivers may be oral or written. What constitutes an implied waiver is a question of fact.

Mere knowledge by an indorser of a maker's actual or prospective inability to pay does not of itself spell out a waiver.

Waiver implied. The following acts would spell out a waiver when notice of dishonor had not been given: (1) Payment of instrument by indorser, in whole or in part. (2) Admission or acknowledgment of liability after maturity. (3) Indorser's agreement, before time for presentment, to collect the instrument. (4) Preventing maker or drawee from paying, as when an indorser strips a corporate maker of its assets, or where a drawer, at indorser's request, stops payment of a check. (5) Indorsing a renewal note.

Waiver not implied: (1) The Brown Corporation, by John Brown, its president, signs a note payable to "ourselves," and both the corporation and Brown individually indorse the note before delivery. Before maturity, The Brown Corporation, by Brown its president, makes an assignment for the benefit of creditors. The note is not paid at maturity. Unless notice of dishonor were given to Brown, he is not liable. As an irregular or accommodation indorser (sec. 304), he was entitled to notice of dishonor. His prospective knowledge of the Corporation's inability to pay and his subsequent knowledge of its default did not spell out a waiver. (2) see section 1488.

When the waiver is embodied in the instrument itself, it is binding upon all parties; but when it is written above the signature of an indorser, it binds him only.

371. Rights of party secondarily liable who pays instrument: reissue. When the instrument is paid by a party secondarily liable thereon, it is not discharged; but the party so paying it is remitted to his former rights as regards all prior parties. He may, if he wishes, strike out his own and all subsequent indorsements, and again negotiate the instrument, except:

(a) When it is payable to the order of a third person and has been paid by the drawer.

(b) When it is made or accepted for accommodation and has been paid by the party accommodated.

J. Discharge

372. Discharge in general. A party primarily liable on an instrument is discharged by any act which discharges the instrument. The reverse is also generally true: An act which discharges the party primarily liable generally discharges the instrument.²⁸ However, parties secondarily liable may be discharged by acts or omissions which do not necessarily discharge the instrument.

373. Discharge of instrument. A negotiable instrument is discharged by:

(1) *Payment in due course.* The Negotiable Instruments Act provides that an instrument is discharged by "payment in due course by or on behalf of the principal debtor" or "by the party accommodated, where the instrument is made or accepted for accommodation." A negotiable instrument is payable in money only, unless the holder is willing to accept a check, draft, new note or other consideration.

(a) *Renewal note.* A renewal note may be accepted in payment of the old one, but if the old note is made to stand as security for the new, it is not deemed paid until the new one is paid.

(b) *Interest.* Unless the instrument provides for interest, no interest is payable until after due date. Thus, a note made on January 15th, due April 15th, and not paid until September 15th would carry interest at the legal rate from April 15th to September 15th, but not from January 15th to April 15th unless the note provided for interest.

(2) *Intentional cancellation or destruction by holder.* The Negotiable Instruments Law provides: "A cancellation made unintentionally, or under a mistake or without the authority of the holder, is inoperative; but where an instrument or any signature thereon appears to have been cancelled the burden of proof lies on the party who alleges that the cancellation was made unintentionally, or under a mistake or without authority."

(3) *Renunciation.* The holder may expressly renounce his rights against any party to the instrument, before, at or after its maturity. Such renunciation must be in writing, unless the instrument is delivered up to the person primarily liable on it, or unless the oral renunciation is based upon an executed consideration.

Examples:

(1) Jones executes and delivers a note to Brown. Before maturity, Brown meets Jones on the street and says, "Forget about that note. I know how things are with you, and I don't want to add financial hardship to your other troubles." Before maturity, however, Brown dies. If the executor, finding Jones' note among Brown's papers, demands payment, Jones is liable on it: The oral renunciation was ineffective.

²⁸ This does not include discharge by operation of law, as in bankruptcy or by the statute of limitations.

(2) If a holder orally agrees to release an indorser on the latter's agreement to turn over valuable property to the holder, and the property is turned over and accepted, the renunciation, though oral, is valid.

(4) *Principal debtor becoming holder.* An instrument is discharged when the principal debtor becomes the holder of it, at or after its maturity. If a past due note, indorsed by the payee but not marked paid, is found by an executor or administrator among the deceased maker's effects, payment of the note will be presumed.

(5) *Any other act which will discharge contract.* An instrument is discharged by any act which will discharge a contract (secs. 213-243).

374. Discharge of parties secondarily liable. A party secondarily liable is discharged by:

(a) *Any act which discharges the instrument.* (See sec. 373.)

(b) *Failure to make due presentment.* (See sec. 318.)

(c) *Failure to give due notice of dishonor.* (See sec. 357.)

(d) *Striking out his name from the instrument.* (See sec. 326.)

(e) *Discharge of a prior party.* If, in the order named, A, B and C are the indorsers of a note, a discharge of the maker by the holder would also discharge A, B and C, who have a legal right to fall back on the maker; a discharge of A would also discharge B and C, who have a right to fall back on A, and so on.

(f) *Valid tender of payment made by prior party.* As to parties secondarily liable, tender, if valid, has the same effect as payment.

Example: X, the maker of a \$500 note bearing three indorsements but making no provision for interest, tenders payment of \$500 to the holder on due date. The holder, insisting upon interest, rejects tender. The indorsers are discharged.

(g) *Release of the principal debtor.* If the holder releases the maker, he thereby releases the indorsers unless he expressly reserves his rights against them. But if, in releasing the maker, he cuts off the indorser's rights against the maker, his reservation of rights against the indorser is worthless: The law releases the indorser.

Example: In *Spies v. National City Bank*,²⁹ the holder obtained judgment against the maker of a note. It then sold the judgment for 50% of its face amount to a dummy acting for the maker. The holder also reserved all rights against the indorser for the unpaid 50%. The legal effect of the arrangement, however, was to cut off the rights which the indorser would otherwise have had against the maker if he paid the note. The court therefore held that the indorser was discharged.

(h) *Renunciation.* (See section 373, subd. 3.)

(i) *Binding extension of time to primary party.* The Negotiable Instruments Act provides that parties secondarily liable are discharged by "any agreement binding upon the holder to extend the time of payment, or to postpone the holder's right to enforce the instrument, unless made

²⁹ 174 N.Y. 222.

with the assent of the party secondarily liable, or unless the right of recourse against such party is expressly reserved."

(j) *Binding agreement by holder modifying original agreement.* Any binding and material modification in the original terms of the instrument made between holder and party primarily liable, without the consent of parties secondarily liable, discharges the latter. It matters not that the modified terms are more favorable to the debtor; parties secondarily liable have a right to be consulted before any agreement on which they are obligated is changed without their consent.³⁰

Example: The holder and maker of a \$5000 demand note with interest at 6% enter into a binding agreement (without the indorser's consent) reducing the interest rate to 5%. The indorser is thereby discharged

K. Checks

375. Checks distinguished from other drafts. A check, as noted in section 281, is a bill of exchange drawn on a bank and payable on demand. However, certain points of difference are to be noted between checks and ordinary bills of exchange or drafts:

(a) A check, unlike bills of exchange generally, is always drawn on a bank or banker.

(b) It is not necessary that the drawer of a bill have funds in the hands of the drawee, but a check in such a case would be a fraud, and in most states, a crime.

(c) Checks need not be presented for acceptance (certification) and, unlike bills generally, are not usually so presented.

(d) The death of the drawer of a check revokes the authority of the bank to pay, whereas the death of the drawer of a bill does not have this effect.

(e) Laches or delay of the holder of a check in presenting it for payment discharges the drawer only in case he has sustained injury by the delay, whereas the rule is otherwise for bills of exchange.

(f) A check is not due until payment is demanded, and the statute of limitations runs only from that time. This is not true of an ordinary bill.

(g) When a check is accepted (certified) at the request of the holder, the drawer and all indorsers are discharged (sec. 379); presentment for acceptance by the holder of a bill of exchange does not have this effect.

(h) By accepting (certifying) a check, the drawee (bank) warrants that sufficient funds are on hand to pay the instrument, and that such funds

³⁰ This is the prevailing rule in this country. "The rule in England and in Massachusetts seems to be quite the contrary, in which jurisdictions it has been held that if the alteration or modification of the contract was for the benefit of the person whose performance is guaranteed, or is not against the interests of the guarantor, the modification would not destroy the guaranty." *Katz v. Leblang*, 243 App. Div. 421. See also *Gould v. Keith*, 9 Cal. App. 2d 284, 49 P. 2d 623; *Baumer v. Du Pont*, 338 Pa. 193, 12 A. 2d 566.

are being set aside for such purpose (sec. 378); acceptance of an ordinary bill of exchange entails no such warranties by the drawee.

376. Right to compel payment: drawer *v.* payee. It is the drawer, not the payee, who has a right of action against a bank for refusal to pay a check. The drawer is a creditor of the bank; the payee is not. A check, unless and until it is certified, does not operate as an assignment of the drawer's funds. If the bank refuses to pay, the payee has his recourse against the drawer (sec. 319), and the drawer, if the refusal is unwarranted, has his recourse against the bank (sec. 1493).

Examples:

(1) X, by fraud, gets a check for \$100 from Y, payable to the order of A, then cashes the check with A, who is innocent of the fraud. Y, learning of the fraud, stops payment. Later, Y becomes insolvent. If A seeks to hold the bank, he will fail. The bank owes him nothing. The check did not operate as an assignment of Y's funds in the bank.

(2) A swindler forges the payee's name to a check, and the bank pays the check. The payee's recourse is limited to the following: He may recover the check from the bank, present it for payment, and then, if payment is refused, he may hold the drawer. The bank may not debit the drawer's account with the amount paid to the swindler.

377. Time within which checks must be presented for payment. The Negotiable Instruments Law provides that "A check must be presented for payment within a reasonable time after its issue or the drawer will be discharged from liability thereon to the extent of the loss caused by the delay." The usual cause of such loss is insolvency of the bank after the check is issued and before it is presented. If no loss is caused by the delay, the drawer remains liable.

Example: Morse gives Winter his check on the X Bank. Winter holds the check for three months before presenting it for payment. In the meantime, the bank has failed. Morse, however, had withdrawn his money before the bank failed. He therefore suffered no loss because of Winter's delay, and Winter may hold Morse on the check.

The statute does not define "a reasonable time." The generally accepted rules are:

(a) If the payee and drawee bank are in the same place, the check should be presented not later than during banking hours on the next business day after receipt of the check.

(b) If the payee is in one place and the bank in another, the check should be forwarded for presentment not later than the business day after its receipt, and should be presented not later than the next business day after its receipt by the forwarder's agent.

The foregoing rules may be modified by special circumstances. In rural communities, a somewhat longer time may be allowed for presentment. Under other circumstances, a reasonable time may require exceptional diligence.

Example: Ingle gives his check on the First National Bank to Case. An hour later Case is informed that a run has started on the bank. He immediately sends his clerk to the bank with Ingle's check. The clerk holds his place in the line until noon, then goes to lunch, after which he goes to the end of the line. At 2 P.M., before the clerk reaches the teller's window, the bank closes its doors and does not reopen thereafter. Others who took their places in the line that morning behind Case's clerk were paid while the clerk was eating his lunch. In a suit by Case against Ingle, the question whether Case would recover would depend upon whether presentment, under these special circumstances, was made within a reasonable time.

Effect of unreasonable delay: drawer v. indorser. Although the drawer of a check is not discharged by unreasonable delay in presentment unless he sustains loss by the delay, this rule does not apply to indorsers. Checks, unlike time paper, are not intended to go into circulation, but are issued with a view to prompt payment. If, instead, a check is negotiated, the payee-indorser and all subsequent indorsers are discharged by any unreasonable delay in presentment after the last negotiation, whether the indorsers have suffered loss through such delay or not.

378. Certification of check: effect of. Certification of a check corresponds to the acceptance of a bill. It makes the drawee bank primarily liable to the holder, who otherwise has no claim upon the bank (sec. 376). Like any other acceptor, the certifying bank not only engages to pay the instrument according to its terms, but guarantees the genuineness of the drawer's signature and his capacity and authority to draw the instrument. Certification, however, goes further than an ordinary acceptance; it warrants that funds on deposit are sufficient to pay the check and are being set aside for such purpose.

The bank indicates certification by writing or stamping upon the check such words as "Certified," "Accepted," "Good," or words of similar import, usually accompanied by the date.

Certification constitutes an equitable assignment of the drawer's funds, which are charged accordingly.

If the bank fails after certification and before payment, its assets are impressed with a trust in favor of the payee to the amount of the check, and the payee has a corresponding preference.

379. Holder *v.* drawer procuring certification. Where the *holder* of a check procures it to be certified, the drawer and all indorsers are discharged from liability. Where the *drawer* of a check procures it to be certified, he remains liable thereon; and if the bank fails or refuses to pay, the drawer may be held for the amount of the check.

Examples:

(1) A creditor gets two checks from his debtor on a Saturday morning before Labor Day. One of the checks has been certified at the behest of the debtor; the creditor has the other check certified later that morning. The following Tuesday morning the bank fails to open and goes into liquidation. The creditor may hold the drawer on the first check, but as to the second, the drawer is discharged.

(2) See section 1495.

380. Effect of refusal to certify check. On principle, it would seem that refusal to certify a check should constitute dishonor and render the drawer liable to the holder, because the drawer of a bill guarantees that it will be accepted. Under the Negotiable Instruments Law, the provisions applicable to bills are applicable to checks unless otherwise provided, and the statute does not otherwise provide. Yet a leading New York case has held that a bank's refusal to certify does not constitute dishonor; that the holder may not on that account proceed against the drawer; that as a matter of right, a check is presentable for payment only; and that a bank has no obligation under the law to certify a check, but that its only obligation is to pay it.³¹

381. Authority to certify. The authority of a bank to certify checks is customarily vested in the cashier. The directors of a bank have no power, merely by reason of their being directors, to certify checks so as to bind the bank, unless the bylaws give them such authority. "The president, the cashier, and, according to some authorities, the teller may, by virtue of their positions, bind the bank by certifying checks when presented to them in due course of business; and it has been held that the authority of one certifying a check for the bank might be shown by evidence of a course of dealing as between himself, his principal, and the bank's customers."³² However,

³¹ *Wachtel v. Rosen*, 249 N.Y. 386; *National Produce Bank of Chicago v. Dodds*, 205 Ill. App. 444.

³² 7 *Corpus Juris* 706.

the authority of an officer to certify checks does not extend to checks drawn by himself.

382. Certification of overdraft. Where a bank mistakenly certifies an overdraft, an innocent holder thereof may collect, but not the depositor himself, who remains liable for such overpayment.

Example: In *Rankin v. Colonial Bank*,³³ plaintiff was given two checks drawn on defendant bank. He took one to the main office of the bank where it was certified, and then took the second check to a branch office where the teller, not knowing of the certification of the first check which had made the account too short to meet the second, certified the second check. It was held that where the second check had not passed out of the plaintiff's hands and no third parties were involved, the bank was liable for certification only up to the amount of the actual balance.

383. Certifying raised checks and raising certified checks. When a bank certifies a raised check, or when a check is raised after certification and is then paid, the bank can recover, because the bank is not bound to know the handwriting or genuineness of the filling up of the check, but only the signature of the drawer.

384. Stopping payment. The drawer of an uncertified check can stop payment at any time before the bank's acceptance (certification), and the bank is bound by such revocation and has no right to pay the check after being thus notified. If it does pay the check after proper notice to stop payment, the bank is liable to the drawer, but the drawer in such case is liable to the holder for the amount of the check unless he has a valid defense against the holder.

If the bank pays a check before the regular banking hours, and the drawer immediately thereafter (but before banking hours) notifies the bank to stop payment, the bank is liable to the drawer, because he had a right to stop payment at any time before due presentment and payment, and there was no *due* presentment and payment.

385. Payment of check after drawer's death. The death of a drawer automatically revokes any outstanding drafts upon his account with a bank. However, a bank is not liable for payment of a check after the drawer's death if it had no reasonable opportunity to ascertain the fact of such death. In some states, banks are given a period of grace after a depositor's

³³ 31 Misc. 227, aff'd 60 App. Div. 629.

death within which they may honor his checks though they know him to be dead.

Right to recover proceeds from payee. When a bank pays a decedent's check to the payee, the bank's immunity does not cover the payee. The fact remains that death automatically revoked the decedent's order on the bank. The check itself did not operate as an assignment of the decedent's funds (sec. 376). Though payment by the bank under these circumstances does not render the bank liable to the estate, such payment, made without the authority of an existing drawer, remains unauthorized, subject to recovery by the estate. Of course, if the check was given in payment of a legitimate claim against the decedent, such claim, unpaid by the drawer while alive, would remain a legitimate claim against the estate, and could be set off against any claim by the estate for the amount of the check. If, on the other hand, the check was issued through fraud or mistake, or for inadequate consideration, or for a consideration that failed (sec. 333, subd. b), or for no consideration at all, the estate would have a right to recover the proceeds, just as the drawer, had he lived, could have rightfully stopped payment.

Example: X gives his favorite nephew a check for \$5000 as a graduation gift. The following morning, before the check is presented for payment, X dies. If the bank, unaware of X's death, pays X's check when the nephew presents it, the bank is not liable to X's estate, but the nephew is. The check was not a gift of \$5000, but of an order for that sum, and the order, or check, did not constitute an assignment of the funds (sec. 376), hence the gift lacked the essential of delivery (sec. 1080, subd. d) and was revocable either by the drawer before death or by his estate after his death.

386. Check delivered to impostor. Where a drawer delivers an instrument to an impostor whom he believes to be someone else; he must bear the consequent loss as between himself and either the drawee or a *bona fide* holder, since the impostor obtained the money by fraud but not by forgery. (See sec. 334, "Indorsement by impostor *v.* indorsement by thief or swindler.")

Examples:

(1) An impostor, posing as Dorne, a creditor, obtains a check from Cole drawn on the Metropolitan Bank and payable to cash. He cashes the check at the bank and then disappears. As between Cole and the bank, Cole must stand the loss: he intended to deliver the check to the person who stood before him though he was mistaken about the impostor's identity.

(2) Suppose the impostor had negotiated the check to an innocent tradesman for value, and the latter was unable to collect the check because Cole had stopped payment in the meantime. In such case the tradesman could collect the amount of the check from Cole.

(3) Suppose the impostor, purporting to represent a charity, got a check

from Cole payable to the order of A, then cashed it with A, who was innocent of any fraud, then disappeared. If A sought to hold Cole on the check, Cole's defense of fraud would be good as against A, because A would not be a holder in due course, but an immediate party (the payee). If A sought to hold the bank instead of Cole, his suit would likewise fail, since the bank would be under no duty to A (sec. 376).

(4) Suppose the impostor, purporting to represent a charity, got a check from Cole payable to the order of the impostor, who then indorsed and cashed it with A, an innocent third party. A could hold Cole if the bank refused payment, since fraud (in the inducement) is no defense against a holder in due course (sec. 333, subd. e).

387. Duty of depositor to examine statements and vouchers.

When banks furnish depositors with statements of their accounts and supporting vouchers, it is the duty of the depositor to examine them without unreasonable delay and to object to any item that he may consider incorrect. If he fails to do this, the account will be deemed correct in the absence of fraud or concealment. A depositor is not concluded by such statements or vouchers as to matters which he cannot reasonably be expected to know. For example, a depositor in most states is not required to ascertain whether *indorsements* are genuine or false; he is not presumed to know, and in fact seldom does know, the signature or indorsement of the payee.

What constitutes an unreasonable delay by the depositor is a question of fact. The statute may fix a depositor's deadline in such cases. For example, the New York statute³⁴ provides: "No bank shall be liable to a depositor for the payment by it of a forged or raised check, unless *within one year* after the return to the depositor of the voucher of such payment, such depositor shall notify the bank that the check so paid was forged or raised." The New York statute goes further, and establishes a *two-year* deadline as to forged *indorsements* in the case of checks drawn on banks.³⁵

388. Check altered through drawer's negligence. We have already noted (sec. 334, subd. B (2), "Negligence inviting alteration") that when a person in drawing an instrument leaves blank spaces so negligently as to invite alteration and justify the holder in assuming that the filling in was regular and authorized, a maker or drawer may be liable to a holder in due course if the instrument is wrongly altered. When the drawer

³⁴ Negotiable Instruments Law, sec. 326.

³⁵ Negotiable Instruments Law, sec. 43.

of a check has prepared it so negligently that it can be altered easily without giving a suspicious appearance and the bank, following alteration, pays the check, the drawer may be prevented by his own negligence from recovering against the bank. This does not mean that a check must be so drawn as to make it impossible for a wrongdoer to tamper with it. As the court said in a leading case: "Now, while the drawer of a check may be liable where he draws the instrument in such an incomplete state as to facilitate or invite fraudulent alterations, it is not the law that he is bound to so prepare the check that nobody else can successfully tamper with it."³⁶

389. Indorsement of corporate checks. A corporation may authorize any officer or employee to indorse on its behalf checks payable to its order. However, such authority to indorse cannot be enlarged or extended; for example, authority to indorse restrictively (sec. 301) does not imply authority to indorse in blank (sec. 299). Thus if a corporate employee with authority to indorse restrictively, cashes corporate checks for his own use by indorsing in blank, the corporation is not bound and may recover the amounts thus cashed. "Any person taking checks made payable to a corporation, which can act only by agents, does so at his peril and must abide by the consequences if the agent who indorses the same is without authority, unless the corporation is negligent * * * or is otherwise precluded by its conduct from setting up such lack of authority in the agent * * *."³⁷

Example: In the Corn Exchange Bank case cited above, N. Radio, Inc. authorized its stenographer to indorse and deposit incoming checks by stamping them, "Pay to the order of the Greenwich Bank, N. Radio, Inc.," followed by the words in her own handwriting, "Percy H. Jones, Treas." The stenographer indorsed numerous incoming checks, "Percy H. Jones, Treas.," and also indorsed her own name thereon, then cashed these checks with various merchants and kept the money. The merchants deposited these checks in their own bank (Corn Exchange Bank), which ultimately paid out the proceeds to the merchants. In sustaining a suit against the Corn Exchange Bank to recover the proceeds of these checks, the Court said: "The business man who authorizes his clerk to take his checks to his

³⁶ *Critten v. Chemical National Bank*, 171 N.Y. 219. See also *Laseter v. Hill*, 218 Ala. 240, 118 So. 252, denying *certiorari*, 22 Ala. App. 485, 118 So. 250; *Greenfield Savings Bank v. Stowell*, 123 Mass. 196, 25 Am. R. 67; *Herington Bank v. Wangerin*, 65 Kan. 423, 70 P. 330, 59 L.R.A. 717; *Fordyce v. Kosminski*, 49 Ark. 40, 3 S.W. 892, 895; *Holmes v. Trumper*, 22 Mich. 427, 435.

³⁷ *Standard Steam Specialty Co. v. Corn Exchange Bank*, 220 N.Y. 480.

bank for deposit does not vest in her so dangerous a power as to preclude him from setting up her lack of authority if she indorses his name thereon in blank and innocent persons cash the checks for her without inquiry."

390. Issuing fraudulent checks, drafts or orders. Penal statutes commonly provide that if a person knowingly issues a check, draft or order against insufficient or nonexistent funds in a bank, he is guilty of a misdemeanor; and if he obtains money or property thereby, he is guilty of larceny and punishable accordingly.

Questions and Problems for Review

1. Define a negotiable instrument. *NY June 1917 (11)*
2. What is the legal significance and effect of the word "negotiable" when applied to commercial instruments? *AI June 1917 (9)*
3. What is the act called by which a nonnegotiable paper is transferred? How is it done? What rights does it convey to the purchaser? *NY May 1931 (8)*
4. Define a negotiable instrument. Name and explain the two characteristics which distinguish a negotiable instrument from an ordinary contract. *AI Nov. 1929 (5)*
5. State three ways in which a negotiable instrument differs from a simple contract with respect to consideration. *NY May 1927 (15)*
6. Blair, a public accountant, rendered professional services to Jenkins without agreement in advance as to the amount of the fee. Upon completion of the work, Jenkins gave Blair his negotiable promissory note for \$2000 payable thirty days after date, in payment for Blair's services. Two weeks thereafter Jenkins had Blair's work appraised by three disinterested experts, all of whom agreed that the fair value of it was \$500. In an action by Blair on this note, can Jenkins successfully defend on the ground of inadequacy of consideration? *AI Nov. 1930 (3)*
7. Explain the difference between an assignable note and a negotiable note and give an example of each. *AI May 1926 (2)*
8. What are the essentials of a negotiable instrument? *NY Nov. 1926 (7)*
9. Write a form for a negotiable instrument, pointing out each essential element therein. *AI Nov. 1925 (II 5)*
10. State all the essential legal requirements of a contract constituting a valid negotiable note. *AI June 1917 (6)*
11. Define a negotiable bill of exchange. *AI Nov. 1918 (NI 3)*
12. Must the authority of an agent to execute and deliver notes or

cheques* for and on behalf of a principal be in writing? *AI May 1918 (3)*

13.

Detroit, Mich., July 5, 1929.

Sixty days after date I promise to pay to the order of O. R. King six hundred dollars at the Citizens' National Bank, Detroit, Michigan. Value received

Frederick Thompson,
By James Thompson,
Attorney-in-fact.

Actually James Thompson had no authority from Frederick Thompson to execute the above note. From whom can a holder in due course recover? *AI Nov. 1929 (7)*

14. The R.I. Company gave the following note in payment for goods purchased:

\$7,500.

Albany, N.Y., June 1, 1920.

Three months after date we promise to pay to the order of A.B. Corporation seventy-five hundred dollars at the Albany Trust Company. Value received.

JOHN SMITH, Pres.
ELMER H. BROWN, Treas.

The note was written on a blank note across the margin of which appeared the words "R.I. Company." The note was discounted for the payee by the Citizens National Bank and upon nonpayment thereof the bank brought suit against Smith and Brown. Could the bank recover? *AI May 1921 (1)*

15.

New York, February 20, 1918.

Thirty days after date I promise to pay to the order of A.B. one thousand dollars.

Signed,

JNO. HENDERSON
By Wm. Henderson,
Atty.-in-Fact.

The note passes in due course to an endorsee.† The agent has exceeded his authority in executing and delivering the note. Is the principal liable or not? *AI May 1918 (4)*

16.

New York, October 1, 1917.

One month after date I promise to pay to John Smith Five Hundred Dollars for value received, negotiable and payable without defalcation or discount.

(Signed) HENRY JONES

Is the above note negotiable or not? Give reasons. *AI Nov. 1917 (2)*

17. A promissory note is by its terms payable in stated installments with a provision that upon default in payment of any install-

* So spelled in the original. The American Institute Board prefers this spelling; the spelling "check" is preferred by the New York Board.

† The American Institute Board prefers the initial letter "e" (endorse), the New York Board, the initial letter "i" (indorse).

ment or interest the whole shall become due. To what extent is the negotiability of the note affected thereby? *AI May 1918 (1)*

18. A promissory note, otherwise negotiable, contained a promise to pay the sum of \$50,000 "in successive semiannual payments of not less than one thousand dollars each, for a period of eight years from date, and the balance then due to be payable on demand thereafter, with interest on the principal unpaid at the rate of six per cent per annum, payable semiannually, together with all taxes assessed upon said sum against said payee or the holder of this note." Explain whether or not the foregoing provision affected the negotiability of the note. *AI Nov. 1933 (6)*

19. Is the following a negotiable instrument?

Topeka, Kansas
Jan. 10, 1927

To George W. Brown, Topeka, Kansas:

Pay to the order of Fred L. Jones \$2000 on account of contract between you and the undersigned.

(Signed) James A. Smith

Accepted

(Signed) George W. Brown.

AI May 1927 (5)

20. State whether the following document is, or is not, negotiable. If not, what does it lack to make it negotiable?

New York, May 1, 1925.

Sixty days after my arrival in London, I promise to pay to the holder James Gray, \$500 for value received. William Smith.

NY June 1924 (8)

21. Bowman, a resident of Middleport, N.Y., purchased a piano from the X Piano Company of Buffalo for \$300, giving the Piano Company \$50 in cash and the following note:

Buffalo, N.Y., May 29, 1906.

\$250.

On or before one year after date I promise to pay to the order of X Piano Company Two Hundred and Fifty Dollars at 418 Main Street, Buffalo, N.Y. Value received with interest.

The piano for which this note is given shall remain the property of X Piano Company until the note with interest is paid.

On June 3, 1906, the payees endorsed the note and transferred it to Buffalo National Bank for value.

On August 6, 1906, Bowman paid to the Piano Company \$50 on account of the note and on December 1, 1906, the further sum of \$100. Both of these payments were accepted. Neither payment ever came into the hands of the Buffalo Bank.

In May, 1907, the note having been presented for payment, was refused, and the bank sued for the full amount. Could it recover? *AI May 1924 (2)*

22. Is the following a negotiable instrument?

Boston, Mass., July 1, 1920. One year after date, for value received, the Y.Z. corporation promises to pay to the order of Adam Brown three thousand dollars with interest at the office of the Y.Z. corporation, Boston, Mass., or at the option of the holder thereof upon the surrender of this note, to issue to the holder hereof in lieu thereof thirty shares of the preferred stock of said Y.Z. corporation and to pay to the holder hereof in cash the interest then due upon said sum. The Y.Z. corporation, by Y.Z., President.

AI Nov. 1920 (1)

23. X executes a promissory note to Y, in which the following clause is inserted: "In the case this note is collected by an attorney, either with or without suit, the maker hereof agrees to pay a reasonable attorney's fee."

The following indorsement appeared on the note: "For value received we hereby guarantee payment of the within note, including interest and cost at maturity, or at any time thereafter demanded." Is such a note negotiable? *NY Jan. 1924 (3)*

24.

January 1, 1928.

"\$500.

"For value received I hereby agree to pay to A. C. Goodwin or order the sum of Five Hundred Dollars (\$500) in five installments of One Hundred Dollars each, on the first day of each of the next following months of February, March, April, May and June, with interest on all unpaid principal at the rate of six per cent per annum payable with each installment; and in the event of any default in the payment of any installment or interest, the whole balance of said principal sum and interest shall be and become immediately due and payable. All payments to be made at First National Bank.

"(Signed) John Smith."

Is this a negotiable promissory note? *AI May 1929 (5)*

25. Are the following notes negotiable or not? Give reasons.

(a) No date, nor place.

I promise to pay to bearer One Hundred Dollars.

Signed A.B.

(b) January 5, 1917.

Due A.B. or order on demand One Hundred Dollars.

Signed C.D.

(c) Chicago, Sept. 5, 1916.

On or before Dec. 1, 1916, I promise to pay to C.D. or order One Hundred Dollars.

Signed A.B.

(d) New York, April 10, 1916.

On I promise to pay to the order of C.D. One Hundred Dollars.

Signed A.B.

AI June 1917 (7)

26. A for value made, executed and delivered to G the following: New York, N.Y., January 23, 1927. I, A, hereby acknowledge my indebtedness to G for services rendered by him, for which I promise

to pay him the sum of Ten Thousand (\$10,000.00) Dollars, and in the event of my death I hereby authorize and direct the payment of the same out of the funds of my estate. Signed A.

(a) Is the instrument a promissory note?

(b) Is it negotiable or nonnegotiable?

(c) When is it due and payable?

Give reasons for each answer. *NY May 1929 (12)*

27. Brown wrote the following, which Collins signed:

Demand Note, New York City, September 19, 1918. Made this 19th day of September, 1918, as follows: This is to certify that I, William J. Collins of New York City, have this day and date borrowed in cash and received in currency the sum of Five Thousand Dollars from one of my friends, Alfred K. Brown of Albany, N.Y., which sum is subject to and payable on demand, with interest at the rate of 6% per year.

When the note is paid in full, I am to surrender the same and receipt it in full.

WILLIAM J. COLLINS.

(a) Is the instrument a negotiable promissory note? Explain.

(b) If Brown sued Collins thereon to recover the sum due, would he succeed? Give reasons. *NY May 1930 (15); NY May 1928 (15)*

28. A made the following promissory note to B:

"January 31, 1909. I, A, hereby acknowledge my indebtedness to B for services rendered by him for which I promise to pay to B the sum of ten thousand dollars; and in the event of my death I direct the payment of this sum out of the funds of my estate. (Signed) A."

In 1911, before A's death, B made demand for payment; payment was refused and suit brought. Could B recover? *AI Nov. 1921 (1)*

29. Is an instrument made payable to "James G. Kelly or Charles Perkins" negotiable? *AI Nov. 1925 (1-2)*

30. What must a negotiable instrument not contain? What are the exceptions to this rule? *AI May 1927 (6)*

31. Plaintiff, before maturity, purchased from the Benz Manufacturing Company several trade acceptances, a copy of one of which is as follows:

Acceptance Number: No. 1 To John Sharp, P. O. 1934 Franklin St., Syracuse, N.Y.: Sixty days after date pay to the order of ourselves at New York, N.Y., the sum ofTwo Hundred.....Dollars. Accepted at Syracuse Trust Company of Syracuse. Firm: J. Sharp. The obligation of the acceptor hereof arises out of the purchase of goods from the drawer. Benz Manufacturing Company, C. H. Strum, Gen'l Mgr.	Trade Acceptance New York, N.Y., Sept. 30, 1932
--	--

Defendant, an acceptor, contends that the instrument is not negotiable because of the words "the obligation of the acceptor hereof arises out of the purchase of goods from the drawer." What holding, and why? *NY Nov. 1932 (13)*

32. Name two things, either of which, if present in a negotiable instrument, will affect its negotiability. *NY May 1930 (4); NY May 1928 (4)*

33. Is the following a negotiable instrument?

New York, June 1, 1921

I hereby certify that James K. Sloane has deposited with me Five Hundred Dollars which I promise to pay to his order on demand with interest from date on the return to me of this instrument and of my guarantee for the note for Five Hundred Dollars dated June 1, 1921, made by said James K. Sloane to Thomas J. Smith.

(Signed) Edward F. Wilson.

AI Nov. 1922 (1)

34. Is it necessary that a negotiable instrument contain the words "value received"? *AI Nov. 1926 (14)*

35. Belknap, for an adequate consideration, gave the following written instrument to Pinney on August 5, 1932:

New York, N.Y.

Thirty (30) days after date I promise to pay to the order of Albert Pinney One Thousand Seven Hundred Fifty Dollars (\$1,750) at Liberty Trust Company. Value received. Interest at 6%.

Robert Belknap

James Silliman

Agents of New York Turbine
Company.

Against whom, when, and for what amount will Pinney be entitled to enforce this instrument? *AI Nov. 1932 (8)*

36. In what particulars is the following paper not in the usual form?

Boston, Mass.

I, Thomas H. Green, promise to pay to James Malone or order Two Hundred Dollars. Value received.

(Signed) THOMAS H. GREEN.

AI May 1923 (1)

37. Are the following instruments negotiable?

(a) "March 1, 1920. I promise to pay to the order of John Smith & Co. on August 30, 1920, in the city of New York, the sum of \$340 for the amount of the second installment on machine purchased of them on this date. William Brown."

(b) "New York, May 1, 1920. Sixty days after date, I promise to pay to John Smith \$5000 for value received. William Brown."

AI May 1920 (2)

38. Under the negotiable instruments law, (a) how would you determine the principal amount of the following note:

January 1, 1924. Three months after date I promise to pay to the order of John Jones the sum of One Hundred Dollars (\$10) value received, with interest.

(Signed) RICHARD SMITH.

(b) Where would you present it for payment? *AI May 1924 (1)*

39. You are treasurer of the A corporation with power to sign commercial paper. Draw and sign a negotiable promissory note binding upon the corporation as maker. *AI Nov. 1926 (5)*

40. What is (a) a collateral note, (b) a judgment note? *AI May 1923 (4)*

41.

\$5000

No. 657

THE FIRST NATIONAL BANK

Newark, N.J., Jan. 15, 1929

E. R. Cater has deposited in this bank Five Thousand Dollars payable to the order of himself on the surrender of this certificate properly endorsed, with interest at $4\frac{1}{2}\%$.

J. H. Benedict, *Cashier*.

Is the foregoing a negotiable instrument? What is it called? What is its use? *AI May 1930 (1)*

42. Define a bill of exchange. *AI May 1921 (4)*

43. Define (a) an inland bill of exchange, (b) a foreign bill of exchange. In what circumstances does the determination as to whether a bill of exchange is inland or foreign become a vital point? *AI Nov. 1923 (3)*

44. What is a documentary sight draft and when is it payable? If a negotiable instrument matures on Saturday, when is it payable? *NY Nov. 1930 (2)*

45. What is a trade acceptance? Explain its use. *AI May 1924 (4)*

46. What is a letter of credit and how is it addressed? *NY June 1922 (4)*

47. (a) What is (1) a commercial letter of credit, (2) acceptance, (3) trust receipt? (b) For what purpose are they chiefly used? *NY May 1931 (7)*

48. The balance sheet of a commercial concern contains among its liabilities an item under the following caption: "Unmatured Acceptances under Letter of Credit secured by Trust Receipts on Merchandise." As used in this connection, define the terms *letter of credit*, *acceptances* and *trust receipt*. *NY Nov. 1931 (12)*

49. What is a negotiable document of title? *NY Nov. 1928 (10)*

50. What is the difference between a negotiable and a quasi negotiable instrument? *NY June 1917 (13)*

51. Name *two* documents of title with reference to goods. How may one determine their negotiability? *NY Nov. 1934 (11)*

52. Whitely owned "bearer bonds" and certificates of stock of a corporation. The certificates were indorsed by him in blank. He

lost the securities in a railway accident. The finder sold the bonds and the stock to Westfall. Westfall acted in good faith and without knowledge of the facts relating to Whitely's loss. What interest does Westfall acquire in the securities? *NY May 1925 (5)*

53. Backus, in the excitement of a railroad accident, lost unregistered coupon bonds and stock certificates endorsed in blank which he had been carrying in a brief case. These were found by another passenger who made no attempt to ascertain or find the loser but two weeks later sold the bonds and the certificates. The purchaser paid full value for them and had no knowledge of Backus' loss. Did the purchaser become the legal owner of the bonds and the certificates? *AI Nov. 1934 (1)*

54. On May 1, 1918, Jones purchased a bill of goods from Gray. Gray agreed, as a matter of accommodation to Jones, to accept a thirty-day note, dated May 10, 1918. Jones made the note and delivered it to Gray on May 1, 1918. Two days thereafter Jones met a violent death. Gray is now confronted with the problem, since he holds a note dated seven days after the death of the maker, does this fact invalidate the note? Explain. *NY Jan. 1922 (6)*

55. A makes and delivers to B a negotiable note payable ninety days after date, but fails to date the paper. B fills in a wrong date and negotiates it to C for value. What, as to C, is the correct date of maturity? *AI Nov. 1926 (9)*

56. A executes and delivers to B an undated negotiable note, payable sixty days after date. B inserts a wrong date (not the date of delivery) and the note passes in due course to C. What is the effect of the insertion as to the maturity of note as to C? Does it avoid the instrument in his hands? *AI May 1918 (2)*

57. A negotiable promissory note is expressed to be payable to the order of X six months after date. Through error A, the maker of the note, fails to date it "January 1, 1927," the date on which it was given. X fills in "July 31, 1926" as the date, and on January 15, 1927, endorses the note to B, who is a *bona fide* purchaser of the note for value without notice that there is anything wrong with the note. B, on February 1, 1927, presents the note to A for payment. A refuses to pay. On February 15, 1927, B sues A, who defends on the ground that his obligation is not due until six months after January 1, 1927. Is the defense valid? *AI May 1928 (4)*

58. Under what condition or conditions does the law merchant govern the treatment of negotiable instruments? *NY Apr. 1933 (6)*

59. What constitutes negotiation under the negotiable instruments law? *NY June 1920 (4)*

60. Is a typewritten indorsement on the back of a check valid? Explain. *NY Jan. 1922 (2)*

61. Are words of negotiability necessary in the indorsement of an

instrument which in its body is in negotiable form? *NY June 1922 (7)*

62. What correction may a payee or endorsee whose name has been improperly spelled in a negotiable instrument make? *AI May 1918 (6)*

63. A indorses B's note in favor of C for \$1000. At the same time he guarantees in writing the payment of another note by B to C for the same amount. Neither note is presented at maturity, and neither is paid by B. C sues A for the amount of the two notes. Can he recover, and if so, how much? Give reasons for your answer. *NY June 1932 (9)*

64. Name three kinds of endorsement. Give an example of each and explain the effect of each. *AI Nov. 1923 (4)*

65.

Detroit, Michigan, October 2, 1928

Thirty days after date I promise to pay to the order of John A. Miller, five hundred and 00/100 dollars at the Second National Bank & Trust Co.
George M. Chapman

Give the circumstances in which each of the following endorsements might have been made on the above note:

(a) George M. Chapman.*

(b) Pay to the order of Lester C. Mayer.

George M. Chapman.*

(c) Pay Lester C. Mayer only.

George M. Chapman.*

(d) Pay Industrial Savings Bank for deposit.

George M. Chapman.*

AI Nov. 1928 (2)

66. Define (a) a general indorsement, (b) a special indorsement. *NY May 1925 (2)*

67. What is the legal effect of endorsing an instrument in blank? *AI Nov. 1917 (3)*

68. Explain "restrictive indorsement" of a negotiable instrument. *NY Nov. 1929 (4)*

69. A note payable to Moore or order is endorsed "Pay to Neil Bartlett for collection" over Moore's signature. It is then endorsed "Pay to Fred Downs" over Bartlett's signature. Downs collects the amount of the note from the maker. To whom does the money belong? *AI May 1927 (7)*

70. How may a "qualified endorsement" be made and what is the effect of such an endorsement? *AI Nov. 1920 (4)*

71. How would you protect yourself against the danger involved

* So in the original. Presumably a typographical error, since the indorser, under these circumstances, would be John A. Miller, the payee.

in the loss of a negotiable instrument endorsed in blank received by you in due course of business? *AI Nov. 1922 (2)*

72. (a) *A* holds *B*'s note for \$5000, which is drawn to the order of *A*. How can *A* transfer the note to *C* and at the same time avoid liability on it?

(b) Mention the various kinds of endorsements and give an example of each. *AI Nov. 1919 (1)*

73. The payee of a note, before its maturity, wrote on the back of it: "I hereby assign all my right and interest in this note to Richard Fay in full. (Signed) Harry C. Witte." The maker failed to pay the note at its maturity and Fay sued Witte as an endorser. Witte defended on the ground that his writing on the back of the note was a qualified endorsement and that he was not liable as an endorser. For whom should judgment be rendered? *AI May 1933 (2)*

74. Tompkins makes a negotiable promissory note payable to the order of the First National Bank, and before delivery Chase writes his name on the back of it. What kind of endorser, if any, is Chase and what is his liability, if any, to the payee and to subsequent endorsees? *AI Nov. 1931 (9)*

75. What is the effect of endorsement of a negotiable instrument (a) By an infant?

(b) Without consideration, by a corporation? *AI Nov. 1920 (2)*

76. Define "holder for value," as used in the Negotiable Instruments Law. *NY May 1929 (1)*

77. What constitutes a party a holder of a negotiable instrument (a) for value, (b) in due course? *AI May 1921 (2)*

78. What is the distinction, in so far as the rights of a holder in due course are concerned, between a negotiable instrument and a nonnegotiable instrument? *NY Nov. 1926 (8)*

79. Is a party who purchases a past due note a "holder in due course"? *AI Nov. 1925 (I-8)*

80. In the consummation of a business transaction between *X* and *Y*, *Y* gave *X* his promissory note payable in six months. Thirty days after receiving the note, *X* sold it to his bank and accepted in payment thereof a negotiable certificate of deposit, payable in six months. This certificate of deposit was paid by the bank and a demand made on *Y* for payment of his note. *Y* then claimed that *X* obtained the note from him by fraud. He further contended that the bank is not a holder in due course, because the certificate of deposit was not payable until after the maturity of the note. Can the bank enforce payment of the note by *Y*? *NY Jan. 1923 (7)*

81. Give an example of a case in which a holder with notice is a holder in due course. *AI May 1927 (8)*

82. Mr. White purchased a used automobile from the Used Motor Car Corporation and gave in part payment therefor his negotiable

promissory note payable sixty days after date. The car was guaranteed to be in perfect running order. The seller sold White's note before maturity to *X*, who became an innocent holder for value and without notice. The car was grossly misrepresented and proved to be worthless; White refused to pay the note at maturity on the ground that he was defrauded. *X* had negotiated this note before maturity to *C*, who had knowledge of the fraud practised on White. Can *C* recover from White on this note? Give reasons for your answer. *NY Jan. 1926 (8)*

83. Allen, by fraud, induces Bates to issue a negotiable promissory note to him. Allen then sells the note to Cameron, who is a holder in due course. Cameron in turn negotiates the note to Davis who, while not a party to the fraud, has full knowledge of it. Can Davis recover from Bates? State the rule involved and the reason for it. *AI May 1930 (9)*

84. *A* sold his automobile to *B*, warranting it to be a 1918 model in good mechanical condition. *B* gave *A* his note in payment of the purchase price, of which note *C* became the holder in due course. *B*, after a few days, found that the automobile was a 1917 model and in such defective condition that its actual value was but a small proportion of the purchase price paid by him, of all of which *X* had knowledge. *X* subsequently purchased the note from *C*. Could he enforce the note against *B*? *AI Nov. 1920 (3)*

85. A promissory note in proper legal form was (a) signed in Hanover, New Hampshire; (b) placed in a mail box in Bennington, Vermont, for delivery to payee; (c) payable in New York City; (d) indorsed over to a third party by payee in Newark, New Jersey. The law of what state governs the rights of the holder in due course under this instrument? *NY Apr. 1934 (6)*

86. By an acceptance what does the acceptor admit and what does the acceptor not admit? *NY June 1916 (6)*

87. McDonald becomes the holder in due course of a note purporting to have been made by Knapp and bearing endorsements in blank by Abbott, Perrin and Pringle. The maker's name was forged. When due the note was duly presented for payment, payment refused, and notice of dishonor given to all parties. Could McDonald collect and from whom? *AI Nov. 1924 (3)*

88. Dupont drew a cheque on the *X* bank for \$1.22 payable to the order of Alice Nugent. This cheque was fraudulently raised to \$3,881.22, and the name of the payee changed to Alfred Nugent. Thereafter, this cheque was endorsed by Alfred Nugent and deposited by him in the *B* bank. The *B* bank endorsed it, guaranteeing all prior endorsements, and collected \$3,881.22 from the *X* bank. Prior to the discovery of the fraud, Alfred Nugent closed his account with the *B* bank and disappeared. Upon whom does the loss fall and why? *AI Nov. 1932 (2)*

89. On the balance sheet of a merchant there appears an item, "notes receivable \$5,695.50." You find these notes on hand or in bank for collection. You also find that the merchant has discounted at his bank notes previously received by him not yet due amounting to \$11,000.00.

(a) Since these discounted notes are no longer held by the merchant, has he any further responsibility or liability?

(b) If so, describe its nature and what effect it may have on the balance sheet. *AI May 1919 (1)*

90. Explain fully the liability of a qualified indorser of a negotiable instrument. *NY Nov. 1927 (4)*

91.

New York, September 12, 1932

Thirty days after date I promise to pay to the order of A.B. One Hundred Dollars.

(Signed) X.Y.

Indorsed in blank "without recourse." A.B. What does this indorser warrant by his indorsement? *NY Nov. 1932 (10)*

92.

New York, April 10, 1916

Thirty days after date I promise to pay to the order of C.D. One Hundred Dollars.

Signed A.B.

Endorsed in blank "without recourse."

C.D.

What does the endorser warrant by his endorsement? *AI June 1917 (8)*

93. Burns lent a sum of money to Atkins, but at a usurious rate of interest. He took a note payable to bearer for the amount of the loan and interest. Burns then sold the note to Wilson but endorsed "without recourse." Wilson could not recover the face amount of the note from Atkins because of the usury and so attempted, by suit, to recover from Burns, the endorser. Could he recover? *AI May 1925 (2)*

94.

Boston, Mass.

January 2, 1927

Ninety days after date I promise to pay to the order of X.Y. Five Hundred Dollars with interest.

(Signed) John Doe

By A.B.

Attorney-in-fact.

Endorsed in blank "without recourse." X.Y.

The foregoing note passes in due course to William Smith. The note, being unpaid at maturity, Smith sues. John Doe is not liable as maker because A.B. had no authority to sign as agent or attorney-in-fact. X.Y. interposes the defense that he is not liable as he endorsed "without recourse." Is such defense good? *AI Nov. 1927 (1)*

95. Royce becomes the holder of a negotiable promissory note in regular form made by *A* to *B* and bearing several full endorsements. He endorses the note to Church for value, but "without recourse." When Church endeavors to collect upon maturity of the note, it is discovered that *A* is an infant and refuses to pay. Church then sues the endorser, including Royce. Has Royce any defense? *AI May 1929 (2)*

96. *A* delivered to *B* the following instrument:

"Jan. 5th, 1925. One month after date I promise to pay to *B*, Seven Hundred Fifty Dollars." (Signed) *A*

B endorsed the instrument in blank before maturity and delivered it to *C* for value. When due, *A* refused to pay and *C* sued *B*. Could *C* recover? *AI May 1925 (1)*

97. Does a person negotiating a negotiable instrument by delivery only incur any liability thereon? Give reasons. *NY May 1929 (8)*

98. Smith is the holder in due course of a negotiable promissory note made by *A* and indorsed by Brown, Green, Black and White. Smith is personally acquainted with Green and, not desiring to hold Green liable as an indorser, cancels Green's signature. Smith then sues the maker and all the indorsers except Green. Against whom will Smith obtain a judgment? Explain. *NY May 1926 (11)*

99. A negotiable note executed and delivered by *A* to *B* passes in due course to and is endorsed in blank by *B*, *C*, *D* and *E*; *F* is the last holder and strikes out *C*'s endorsement. What is the liability of *C*, *D* and *E* on their endorsement? *AI Nov. 1918 (NI 5)*

100. What is an "accommodation party" to a negotiable instrument and what is his liability? *AI Nov. 1922 (4)*

101. You desire to borrow \$1000 from the *X* bank. As maker you execute a promissory note for that sum due ninety days from date of execution. The *X* bank refuses to accept the note until you have it indorsed by a responsible indorser. You secure *B*, who indorses the note. You then take the note to the *X* bank which discounts it for you. *B* neither gave nor received any consideration for his indorsement. When the note matures, you are unable to pay. Has *X* bank the right to recover from *B*? Give reasons. *NY May 1930 (13)*; *NY Nov. 1927 (14)*

102. As an accommodation to *B*, *A* on June 1, 1919, endorsed *B*'s note for \$1000 payable to *C*'s order on July 1, 1919. On July 2, 1919 *C* endorsed and delivered the note to *D*. What rights, if any, has *D* against *A*? *AI Nov. 1919 (4)*

103. *A* made a note for the accommodation of *B*. *B*, before maturity, transferred it for value to *C*, who, at the time of taking the note knew that *A* was an accommodation party. Upon maturity, the note not being paid, *C* sued *A* thereon. Can he recover? *AI May 1920 (3)*

104. Jones, a farmer, owed Smith a sum of money for feed and seeds purchased. Jones, together with his wife, gave a promissory note to Smith for the amount of the debt. In a suit by Smith, the note having been dishonored at maturity, Mrs. Jones defended on the ground that as she was not liable for the goods, the note was without consideration as to her. Was the defense good? *AI Nov. 1927 (3)*

105. The White Yarn Knitting Company borrowed \$1500 from the bank on its note. The loan was purely an accommodation. After the note was executed by the officials of the Knitting Company, A and B, both of whom were stockholders and directors in the Knitting Company, consented to indorse the note, by partial payments, to the sum of \$800. At that time A, without the knowledge of B, requested the bank to release him as indorser, which the bank did for a consideration of \$200. The Knitting Company failed to pay the balance of the note and the bank commenced action against B as indorser. Will the bank succeed? *NY Jan. 1923 (1)*

106. E gives F a note due in six months from date, such note being indorsed by two friends of E. At maturity E makes payment on account and asks for an extension of sixty days. F grants the request and E gives a new note for the balance due in sixty days from date. In the new note, E inserts the words "that the original note with the indorsers stands as collateral." Does F's action in granting E the extension discharge the indorsers on the original note? *NY Jan. 1924 (5)*

107. B, a member of the firm of A and B, indorses the firm name on a promissory note for the accommodation of his brother, who is entering into business. Before the note is due, A discovers what his partner has done, and tells him that he is not going to be responsible for it but fails to notify the payee of the note. Is A liable together with his partner B? Explain. *NY Jan. 1916 (14)*

108. S owed W \$3000. He was unable to pay W but told W to borrow from a third party a note on which to raise money, and stated that he would have the note discounted by a bank. W secured the following, which was indorsed "R Manufacturing Corporation by T, Treasurer":

\$3000.00 New York, N.Y., October 8, 1928.

Three months after date we promise to pay to the order of ourselves Three Thousand Dollars at X Trust Company, Trenton, New Jersey, Value Received, R Manufacturing Corporation.

T, Treasurer.

W delivered the note to S who had it discounted by X Trust Company and converted the net proceeds of the note to his own use. The note was not paid at maturity and X Trust Company assigned its interest therein to J, who sued R Manufacturing Corporation thereon. Will J recover? Give reasons. *NY May 1929 (15)*

109. When a person negotiates or transfers for value a document of title by indorsement or delivery, what warranties are present? *NY Nov. 1930 (9)*

110. What are personal defenses to a negotiable instrument and in what circumstances may they be invoked? Name some personal defenses. *AI May 1923 (3)*

111. Explain the difference between personal defenses and absolute defenses in an action on a negotiable instrument, and name some instances of each kind. *AI May 1929 (9)*

112. A note nonnegotiable in form is executed and delivered by A to B and endorsed by B to C. A refuses to pay it when due, claiming want of consideration. C brings suit against A, averring that he was a holder in due course. Can A successfully defend the action if want of consideration is established? Give reasons. *AI Nov. 1918 (NI 1)*

113. Suppose that the above note had been negotiable, would A's defense of want of consideration be a bar to C's recovery or not? Give reasons and state the rule applicable to the principle involved in this and the foregoing question. *AI Nov. 1918 (NI 2)*

114. On December 1, 1910, A gives to B the following instrument:

January 30, 1911, after date I promise to pay to B Four Hundred Dollars at 25 Broad St., New York, N.Y.

(Signed) A

B endorsed the instrument to X before maturity for value. A, the maker, did not pay on the due date and defended suit by X on the ground of lack of consideration. Could X recover? *AI Nov. 1927 (2)*

115. Taylor held Thompson's note for \$400. Taylor was indebted to Thompson on an open account for \$400. Taylor transferred the note to King in the usual course of business for value. When due, King presented the note to Thompson, who refused payment on the ground that Taylor owed to him, Thompson, an amount equal to the note. Did Thompson, the maker, have a good defense? *AI Nov. 1924 (1)*

116. A subscribes for a certain number of shares in the B Corporation upon its formation, but only 60% of the subscribed capital has been called. A has paid all installments called and in addition has lent the B Corporation \$3000 for which he has taken the corporation's negotiable promissory note and has transferred the note to X. On the due date X demands payment, but the company calls for further capital installments on A's subscription and sets up the amount of the call as an offset to the note. Is the corporation's procedure correct? *AI May 1926 (1)*

117. A drew a check in favor of B or order, leaving the amount blank. He authorized B to fill it in for a sufficient amount to pay

a claim which he (*A*) owed *X*, the exact amount of which was not known at the time the check was drawn. It was understood between *A* and *B*, however, that in no event should the amount inserted in the check exceed \$200. *B* fraudulently filled in the check for \$800 and gave it to *C* in payment of a bill of goods which he (*B*) purchased from *C*. To what amount is *C* entitled? *NY Jan. 1916 (10)*

118. What is the legal effect of a forged signature to a negotiable instrument? *AI May 1918 (5)*

119. *G*, holding himself out as the representative of one Lieut. *X*, head of a navy tuberculosis camp, obtained from *A* a cheque for \$100.00 to the order of Lieut. *X* as a contribution to the camp fund. *G* endorsed the cheque with the name "Lieut. *X*" and obtained the cash thereon from *B*. *A* later ascertained that there was no such person as Lieut. *X* and that there was no such camp fund as was alleged by *G*. *A* therefore directed his bank to refuse payment of the cheque when presented. This direction the bank carried out. *B* thereupon brought action on the cheque to recover from *A*. Could he succeed? *AI Nov. 1921 (2)*

120. What is the effect of a material alteration of a negotiable instrument and what constitutes a material alteration? *AI May 1922 (3)*

121. Best made a promissory note jointly with Kelly for Kelly's accommodation. Kelly altered the note into the note of a corporation, in which both were officers, forging other signatures and causing Best's signature to appear as that of a personal endorser of the note. The *X* Bank, a holder in due course, sued Best personally upon this endorsement. Could it recover? *AI Nov. 1928 (5)*

122. Rowe, private secretary for Foster, brought to Foster a cheque for signature payable to cash. The cheque was made out in figures for \$50.00, but no words were inserted in the space left for writing. Rowe raised the cheque to \$500.00, which Foster's bank paid. Was the bank liable? *AI May 1922 (4)*

123. A certificate of stock for 100 shares of the capital stock of the Bond & Share Company, issued to Lovett & Co., was endorsed by Lovett & Co. in blank and then sold for value to Whitestone & Co. who did not fill in their firm name or otherwise alter the certificate. Thereafter it was stolen from Whitestone & Co. The thief erased the name of Lovett & Co. as the stockholder and their signature as endorser, inserted the fictitious name of Adolph Zitman as stockholder, wrote Zitman's name as endorser, and pledged the certificate with Brown & Co., who received it for value in good faith and without notice or knowledge of the theft or alteration. Does the loss fall upon Whitestone & Co. or upon Brown & Co.? *AI May 1933 (4)*

124. *A* gave to *B* a negotiable promissory note for \$100, the note being payable to "*B* or bearer." The note was transferred several

times by delivery only, without endorsement, and came into the hands of *R* as a note for \$1000, the alteration not being at all apparent on the face of the instrument. What can *R* do with reference to enforcement? *AI May 1926 (3)*

125. May a person repudiate a promissory note made by him during his minority; and if so, what obligation does the law lay upon him? *NY June 1919 (10)*

126. *J* subscribed for shares of stock of *E*, Inc., giving in payment his negotiable promissory note for \$1000 payable six months thereafter. *E*, Inc., sold the note for \$900 before maturity to *F* who had knowledge that the note was given for stock of *E*, Inc., purchased by *J*. *J* knew the note was to be sold. The note was not paid at maturity. The stock certificate was never issued and delivered to *J*. *F* sued *J* on the note. Can he recover? Give reasons. *NY Nov. 1929 (12)*.

127. Fogarty gave Benson his check for a valid obligation. Benson transferred this check to Smollett in payment of a gambling debt. Subsequently, Benson alleged to Fogarty that he had lost the check, and asked him to stop payment on it. Later, Fogarty learned what had actually happened, and issued a second check in payment to the attorney for one Casety, to whom Smollett had transferred the original check for a legal consideration.

Benson sues Fogarty for payment of the original debt, contending that Fogarty was under no obligation to pay the check to Casety, since the check, having been transferred from Benson to Smollett in payment of a gambling debt, was void, even in the hands of a holder in due course.

Fogarty contends that his indebtedness to Benson was discharged by his acceptance and transfer of the check.

Decision for whom, and why? *NY Oct. 1933 (14)*

128. John Green and Richard White took part in a game of poker. In the game Green lost \$60, \$30 of which was won by White. At the time the game broke up, Green had but \$30 in his pocket, which he gave to one of the other players whom he did not know so well as he did his friend White. To the latter he gave a check for \$30. White, in turn, indorsed the check, making it payable to William Smith, his landlord, to whom White delivered the check in payment of rent.

At the opening of banking hours next morning Green notified the bank to stop payment on the check, which was done. Upon refusal by the bank to pay the check, Smith undertook to enforce its collection from the payee bank, and to that end instituted a suit. Can Smith recover from the bank? Answer fully and give reasons. *NY June 1922 (1)*

129. *B* signed a promissory note in blank, leaving it on his desk. During *B*'s absence from his desk *A* took the note, filled it in for two hundred dollars and sold it for value to *C*, who knew nothing about

the method by which *A* came into possession of the note. Could *C* recover on the note from *B*? *AI Nov. 1923 (1)*

130. In what circumstances is it necessary for a holder to present a bill of exchange for acceptance? *AI Nov. 1928 (9)*

131. How soon after presentment of a bill of exchange is the drawee obliged to decide whether or not he will accept the bill? *NY June 1919 (9)*

132. Beach drew a bill of exchange on Washburn as drawee and gave it to the payee for adequate consideration. The payee personally presented it to Washburn who immediately became enraged and tore up the bill. Against whom has the payee any right of action on the bill? *AI Nov. 1933 (1)*

133. A drawee of a draft, in answer to an inquiry by the payee, wrote that he would honor a draft for \$1000 by Samuel Thompson. A draft on this drawee by Samuel Thompson for \$1000 was duly presented, but acceptance was refused because the words "with exchange" had been added. Can the payee collect from the drawee? *AI Nov. 1934 (8)*

134. What is a referee in case of need? What is his liability? *NY Nov. 1928 (8)*

135. On January 7, 1932, Baldwin drew a bill of exchange on Clute payable March 7, 1932, to the order of Dillingham. On January 12, 1932, Dillingham presented the bill to Clute who refused to accept it. On the same day, Dillingham protested the bill for nonacceptance. On January 27, 1932, Everett, who desired to protect Baldwin's credit, accepted this bill.

(a) What is the technical name for this kind of acceptance?

(b) How must such an acceptance be made?

(c) Just what did Everett, by this acceptance, engage to do? *AI May 1932 (4)*

136. Is it necessary to present an acceptance to the acceptor at its maturity in order to hold parties secondarily liable? *NY June 1923 (5)*

137. *A* draws a note to the order of *K* for value, has it indorsed by *D* and *E* and delivers it to *K*. The note matures July 1, 1920. On that day *K* presents the note to *A* for payment. *A* refuses payment. What must *K* do to hold the indorsers? *NY June 1922 (13)*

138. Among the notes receivable of *E.F.*, whose books are being examined, are two promissory notes past due. The maker of both is *A.B.*, whose financial responsibility is doubtful. One of the notes bears the endorsement of *B.C.*, who is known to be "good." What steps should have been taken by *E.F.* on the dates when each of these notes fell due to protect his rights? *AI May 1919 (3)*

139. *A* received from *B* a negotiable promissory note for \$2500 payable on demand to the order of *B* and endorsed by *B* to the order

of *A*. Six months later the maker of the note became insolvent. Has *B* any defense to an action by *A* against him as endorser? Explain fully. *AI Nov. 1919 (2)*

140. What is the duty of a bank, at which a note is made payable, and in which the maker has sufficient funds on deposit, when the note is presented for payment? *AI May 1924 (3)*

141. What is a "notice of dishonor" and what is its purpose? *AI Nov. 1922 (3)*

142. What is the purpose of a protest? What instruments must be and what instruments may be protested? What instruments need no protest? *AI Nov. 1917 (1)*

143. What is the meaning of the act of a notary public in protesting a dishonored negotiable instrument? *NY Jan. 1923 (9)*

144. Barr and Nelson, copartners, received in the course of business a note made by Nash. Barr endorsed the note in the firm name. The note not being paid at maturity was protested by the holder and notice given to Barr. In a suit against Barr and Nelson as endorsers, Nelson defended on the ground that he had not had notice. Was his defense good? *AI Nov. 1924 (8)*

145. Jordan was the holder in due course of a promissory note made by *A* and indorsed by Conroy, White and Holden. This note was duly presented to the maker at maturity and payment was refused. Thereupon Jordan caused the notary public, who protested the instrument, to send written notices of dishonor to each of the indorsers. These notices were mailed in envelopes, properly addressed and stamped, to each of the indorsers, but, owing to the miscarriage of the mail, such notices were never received by any of the indorsers. In the suit brought by Jordan against the maker and each of the indorsers, the indorsers set up as a defense the fact that they had never received any notice of dishonor. Will the indorsers succeed in this defense? Give reason. *NY May 1926 (12)*

146. The *X Dress Corporation* made a promissory note payable to the order of "ourselves." Brown was president of that corporation and as such he signed the note. The note was endorsed before maturity by the maker corporation and by Brown individually. Prior to the due date of the note, the *X Dress Corporation* made an assignment of its assets for the benefit of creditors and said assignment was executed by Brown as president. The note was not paid at maturity, and the maker corporation and Brown individually were sued. Notice of dishonor of the note had not been given to Brown. Can Brown be held as endorser? *AI May 1934 (8)*

147. Knapp became an accommodation endorser on a note made by Styles. When the note matured Styles failed to pay and it was paid by Knapp. Knapp sued Styles on the note for the amount due. Styles set up the technical defense that the note was discharged by Knapp's payment and that therefore no suit could be based on it. Was he correct? *AI Nov. 1929 (9)*

148. *A* entered into an agreement to purchase certain shares of stock of the *X.Y. Company*, the agreement providing for the giving of a note for the amount of the deposit on the signing of the contract. The agreement further gave *A* the right to cancel his agreement to purchase on notice to the *X.Y. Company*. *A* gave the note. The *X.Y. Company* induced *C* to endorse the note as an accommodation, and the note was thereupon discounted at a bank. *A* duly canceled his purchase agreement, but the note was not returned. On maturity, since neither *A* nor the *X.Y. Company* paid the note, *C* did so; and the note, endorsed in blank, was turned over to him. *C* sued *A* on the note. Could he recover? *AI May 1925 (3)*

149. How is a person secondarily liable on a negotiable instrument discharged from liability? *AI May 1922 (2)*

150. By whom must payment of a negotiable instrument be made in order to extinguish it? *AI Nov. 1927 (4)*

151. Styles made a note to Johnson dated January 1, 1924, and due April 1, 1924. The note contained no provision as to interest. The note was not paid by Styles when due but it was allowed to run until September 1, 1924, when Styles paid it. Could Johnson collect any interest? *AI Nov. 1924 (2)*

152. Jones executed a negotiable promissory note payable to the order of Brown. Prior to maturity of the note, Brown met Jones on the street and told him that he expressly renounced his rights against Jones on this note because he felt that Jones was not financially able to pay it without imposing undue hardship on Jones' family. Brown died before the note fell due; his executor found the note among his papers, and the executor brought action against Jones. For whom should judgment be given? *AI May 1931 (2)*

153. A past due note, endorsed by the payee, but not marked paid, is found by an administrator among the deceased maker's effects. What is the rule of law as to the presumption of its payment? *AI Nov. 1917 (4)*

154. Thompson gave a promissory note, endorsed by Sherwood, to Babcock. This was a demand note for \$5000 with interest at six per cent. Later, without Sherwood's knowledge, Babcock made a valid agreement with Thompson reducing the interest rate to five per cent. Upon Thompson's failure to pay the note, Sherwood contended that he had been discharged from liability because Babcock had changed Thompson's agreement. Is his contention sound? *AI Nov. 1930 (7)*

155. *A* sold to *B* a case of dry goods and accepted *B*'s check in payment therefor. The check was drawn on the Overseas National Bank and was in due course presented by *A* for payment. Although there were sufficient funds in the bank to pay the check, the bank refused payment without giving any reason. Can *A* enforce the collection of the check against the bank? Give reasons. *NY Jan. 1921 (6)*

156. *A* delivered his cheque to *B* for \$150 in payment for a horse and later gave notice to the bank on which it was drawn not to pay it. What are *B*'s rights (a) against the bank and (b) against *A*? *AI Nov. 1919 (3)*

157. What is considered a reasonable time for the presentation for payment of a cheque? *AI June 1917 (10)*

158. Ingle gave a cheque for \$142 drawn on the First National Bank of the town of *X* to Case, who received it on the morning of November 19, 1930. Case sent his clerk to the First National Bank, on which a run had started at 9 A.M. The clerk took his place in line, which he held until 1 P.M. when he left and went to lunch. Upon his return he took his place at the end of the line, but the bank stopped paying at 2 P.M., before the clerk had reached the paying teller's window, and the bank did not reopen thereafter. Other persons who took places in the line after the clerk had joined it in the morning had their cheques cashed. Ingle had sufficient funds in the bank to meet all cheques drawn by him. Can Case recover in an action against Ingle? *AI May 1933 (7)*

159. In counting the cash in a mill office you find as part of the cash cheques which have been received from customers subsequent to the last bank deposit, which was made a week prior to your visit. The cheques are drawn on various widely scattered banks, including the mill's own bank, which is three miles away on a trolley line.

(a) What does the law require the holder of cheques to do?

(b) What danger, if any, may this mill incur in the collection of these cheques when it makes its next deposit? *AI May 1919 (2)*

160. *A* draws a check payable to *C* who indorses to *D* 500 miles away. *D* indorses the check to *X* in the same place. All the parties act promptly except *X* who deposits the check three days after its receipt in a local bank, which forwards it to the drawee's bank. In the meantime the drawee has failed and afterward declares dividends amounting to 50%. *X* brings suit to recover. Will he recover and why? *NY June 1916 (10)*

161. Suppose that the holder of a check does not present it for payment within a reasonable time and the bank fails: who is the loser, the holder or the drawer? *NY May 1930 (8)*; *NY May 1925 (13)*; *NY Jan. 1925 (15)*; *NY June 1920 (14)*; *NY Jan. 1918 (3)*

162. (a) How does the certification of a cheque by the bank operate to change its nature in the hands of a holder?

(b) Describe the words necessary to effect certification. *AI May 1919 (4)*

163. Andrew J. Morse drew a cheque on the A.B. Bank to the order of Samuel Winter in payment for goods purchased. Winter held the cheque more than three months before presenting it for payment. During that time the A.B. Bank failed. Morse had, however, withdrawn his deposits before the failure. Was Morse released from liability on the cheque? *AI May 1923 (2)*

164. Smith sold Peters a piece of property. Smith gave Peters a warranty deed of title, and Peters gave Smith a certified check in payment. Before this check was presented by Smith for payment, the certifying bank went into the hands of a receiver. Has Smith a preferred claim against the bank? Why? *NY Apr. 1934 (13)*

165. The drawer of a cheque has it certified and delivers it to the payee. In the afternoon of the same day the bank fails. Can the payee collect from the drawer? *AI Nov. 1925 (1-10)*

166. *A* having received from *B*, in payment of a debt, *B*'s cheque for \$10,000 drawn upon the *X* Bank, endorsed it to the order of *C*, who on the same day procured its certification by the bank. What is the obligation, if any, assumed by the bank upon certifying? What effect, if any, does such certification have upon the liability of *A* and *B* on the cheque? *AI May 1920 (1)*

167. *A* gave his check payable to order of cash to *X* in the sum of \$300 for goods sold and delivered. *X* immediately rushed to the Butchers Bank on which the check was drawn and had it certified. A week later the Butchers Bank became bankrupt, and *X* was unable to collect anything on the check. *X* tells *A* that he can have the check back, and that *A* should give him cash for the goods sold. *A* refuses to do this and *X* sues *A* for \$300. How would you dispose of the case? Explain. *NY Nov. 1930 (14)*

168. *A* is the payee of a certified check of which *X* is the drawer and which has been certified by the bank at the instance of *X* before delivery. One day after the check is issued *A* indorses it to *B*, who presents it to the bank for payment on the day on which he receives it. An hour before *B* arrives at the bank, the bank has closed its doors due to insolvency. What are the rights of *B* against *X*? Give reasons. *NY June 1922 (15)*

169. *Y* gave *X* a cheque for \$1500 in payment of a debt. The cheque was drawn on the Union Trust Company. *X* had the cheque certified by the Union Trust Company. On the following day, when *X* was about to deposit the cheque in his own bank, *X* learned that the Union Trust Company had failed at the opening of business that morning. *X* then claimed that *Y* must make good for the cheque. Was *X* correct in his contention? *AI Nov. 1923 (2)*

170. *W* gave his check for \$500 to *B* drawn on *N* Bank. *B* presented the check to *N* Bank for certification, which was refused. *B* immediately sued *W* to recover \$500 without putting the check through for collection in the regular way. (a) Can *B* recover? Give reasons. (b) Was *N* Bank obliged to certify the check when it was presented for certification? Give reasons. *NY Nov. 1929 (11)*

171. Have the directors of a bank the power to certify checks? *NY Jan. 1921 (8)*

172. Henry Green, who is a cashier of the Springtown National Bank, draws his individual check against his own account in the bank, and then certifies it as cashier. Can the holder of such a

check enforce it against the bank? Give reason for answer. *NY Jan. 1921 (10)*

173. Jones, in order to take up an out of town draft, draws his check on the bank for the required amount, although his balance in the bank, subject to check, is less than the amount needed. The bank by mistake certifies the check. Can the bank collect the amount of the overdraft from its depositor? Give reasons. *NY Jan. 1921 (7)*

174. A bank certified a check that had been altered by changing the date and the name of the payee, and by raising the amount. Then subsequently the bank paid the check on presentation. Shortly after having paid the check the bank sued for the amount thus paid. Can the bank recover? Or does the certification of the check amount to a warranty of the genuineness of the body of the check, as well as of the payee and amount? *NY Jan. 1918 (11)*

175. Green drew his check to Jones in payment of merchandise purchased. Jones, in order to obtain an additional amount of money, raised the check after it had been certified. He then induced Black to cash the check at the increased amount. Has the bank any right to recover against Black? Explain. *NY Jan. 1925 (5)*

176. What is the duty of a bank in case a drawer stops payment on a check? Can it legally refuse payment in all cases where demand is made to stop payment? *NY June 1919 (7)*

177. When a bank pays a check drawn upon it, to the holder thereof, before the regular hour for the beginning of business, and the drawer of the check immediately thereafter, though before the hour for the opening of business, requests the bank not to pay the check, is the bank in any way liable to the drawer? *NY June 1923 (15)*

178. What is the liability of a bank for payment of a check after the death of the drawer? *NY Jan. 1919 (8)*

179. *X* represents to *Y* that he is soliciting money for a charity and succeeds in getting *Y* to draw a cheque payable to *X* for \$100. *X* endorses the check to *A*, an innocent third party, who has no notice of any defenses. *X* receives from *A* for the cheque \$100, which *X* keeps. *X*, as a matter of fact, did not represent the charity. After the cheque has passed to *A*, *Y* learns that he has been defrauded by *X*, and he therefore stops payment on the cheque. The bank on which the cheque is drawn does not pay the cheque when it is presented by *A*. *A* sues *Y* on the cheque, and *Y* defends on the ground that the cheque was originally obtained from *Y* by fraud. Is the defense valid? *AI May 1928 (2)*

180. In the preceding question assume that *Y*, after the transactions mentioned and before suit is filed, becomes insolvent so that it will be futile for *A* to try to collect anything from him. If such were the case, could *A* recover from the bank on which the cheque was drawn? *AI May 1928 (3)*

181. Is a bank depositor, having a cheque account, required to verify the correctness of his monthly balance as shown by monthly statement rendered by the bank and by the returned vouchers? *AI May 1926 (4)*

182. What statutory limitation covers a bank's liability for payment of a forged or raised check after its return to the depositor of the voucher of such payment? *NY Apr. 1933 (5)*

183. A opened an account with the X Trust Company in November, 1919, by a deposit of \$75,000. On December 29, 1919, the bank paid out of the account \$5000 on a cheque on which A's signature had been forged. On January 2, 1920, A receipted for a statement of the account by the bank and for eighteen vouchers or canceled cheques attached thereto, one of which was the forged cheque. Since A customarily delegated to his secretary the work of examining statements and keeping the cheque-book, the forgery was not immediately discovered. In March, 1921, the forgery was discovered by A through the report of the bank of an overdraft of the account. The bank refused to make good on the forged cheque and A sued. Did the bank have any defense? *AI Nov. 1921 (4)*

184. K, the drawer of a check on the West Side National Bank, prepares it negligently so that it can be easily altered. Alterations are made by raising the check from five dollars to sixty-five dollars. Can K recover from the bank by notifying it within a year? If so, why? If not, why not? *NY June 1921 (6)*

185. N Radio, Inc., authorized Jane Cohen, its stenographer, to indorse, with a rubber stamp, checks received for deposit, as follows: "Pay to the order of the Greenwich Bank, N. Radio, Inc." Her authority to indorse was limited strictly to the use of this stamp to be followed by the words in her handwriting: "Percy H. Jones, Treas." She indorsed eleven checks, aggregating \$329.79, drawn to order of "N Radio, Inc., Percy H. Jones, Treas." and also indorsed her own name thereon. Nine of the checks were cashed for her by one businessman, and two by another. These men deposited them to their respective credit in the Corn Exchange Bank which paid out the proceeds to such depositors in the regular course of business. Jane Cohen converted the money to her own use. The good faith of Corn Exchange Bank and of its depositors is conceded and no claim is made that N Radio, Inc., was negligent. N Radio, Inc., sued Corn Exchange Bank to recover \$329.79. Will it succeed? Give reasons. *NY Nov. 1928 (12)*

186.* Does the failure of the maker of a promissory note to place thereon the necessary revenue stamps as required by law deprive the note of its negotiability, or vitiate the rights of a person who received the note, lacking such revenue stamps, as a holder in due course? *NY June 1923 (14)*

* This question, timely when framed, has been rendered obsolete by repeal of the tax.

CHAPTER IV

Sales

391. Scope of chapter. In this chapter we summarize the nature and elements of sales and contracts to sell personal property, the requirements of the statute of frauds governing sales, the question of when title passes, the warranties, express and implied, that go with a sale, the remedies available to seller and purchaser, and the more important provisions relating to conditional sales.

A. Nature and Elements

392. Law governing sales: Uniform Sales Act. As shown in the table on pages 12-13, the majority of states have adopted the Uniform Sales Act which formulates the rules governing sales of personal property. On all matters not covered by the statute, the rules of the common law apply. (See sections 6 and 15.)

393. Sale *v.* contract to sell. The Uniform Sales Act distinguishes between a sale and a contract to sell as follows:

"A *sale* of goods is an agreement whereby the seller *transfers* the property (title) in goods to the buyer for a consideration called the price."

"A *contract to sell* goods is a contract whereby the seller *agrees to transfer* the property (title) in goods to the buyer for a consideration called the price."

The distinction is between an actual present transfer (sale) and an agreement to transfer in the future (contract to sell). The former is sometimes called an *executed sale*, and the latter, an *executory sale*.

Importance of distinction. The distinction between a sale and a contract to sell may become important. A sale of "future goods" (sec. 400) passes no title; it merely operates as a contract to sell such goods.¹ A sale vests immediate title in the buyer, including the benefits and risks of ownership.

¹ *Bates v. Smith*, 83 Mich. 347, 47 N.W. 249.

394. **Sale, exchange and gift distinguished.** A sale is the transfer of title to personal property for money; an *exchange*, or *barter*, is the transfer of title in one chattel for title in another. The Uniform Sales Act governs both sales and exchanges.

A sale is distinguishable from a gift in two respects. (1) A sale involves the transfer of title, but not necessarily an immediate transfer of possession; a gift is invalid without an immediate transfer of possession. (2) A sale necessarily involves a consideration, or price; the essence of a gift is a transfer without consideration. (See sec. 1079.)

395. **Sale *v.* bailment.** A sale or exchange involves the transfer of title, a bailment the transfer of possession. Hence if I give you iron ore in exchange for pig iron to be smelted from that ore, the transaction is a bailment because I retain title throughout; but if you may give me *any* pig iron for my ore, I part with title to the ore in exchange for pig iron, and the transaction is an exchange. (See sec. 548.)

396. **Sale *v.* consignment.** A sale transfers title with or without immediate possession. A consignment transfers possession, either (a) for the purpose of shipment or transportation, or (b) for the purpose of sale. In (a), the parties involved are the *shipper* and *carrier*, and the rights and obligations of the parties are governed by the law of *carriers*. In (b) the parties are known as *consignor* and *consignee*, and the rights and obligations of the parties are governed by the law of *agency* and of *sales*.

In the ordinary case, a consignee is the agent of the consignor in the sale of goods. Since he does not own the consignment, he is liable for conversion (sec. 29) if he uses the proceeds; but since he is authorized to sell, an innocent purchaser for value gets title, regardless of what the consignee does with the money.

397. **Divisible *v.* indivisible contract of sale.** The distinction between entire and divisible contracts has already been pointed out (sec. 177). A sale or a contract to sell calling for a single delivery, or a single, lump sum price, would be construed as entire, or indivisible, though it contained a large assortment of items. On the other hand, a sale or a contract to sell is divisible if it has separate and distinct parts and creates separate and distinct obligations; as, for example, when

a vendor sells, under the same contract, a horse, a cow and an automobile, involving different delivery dates and separate prices for each item.

398. Essentials of sales transaction. The essentials of a sales transaction correspond to those of any other contract, whether executed (as in a sale) or executory (as in a contract to sell). There must be (a) parties having capacity to contract, (b) consideration (price), (c) subject matter (possessing not only validity, but actual or potential existence), and (d) mutual assent (including intent to pass title). Transfer of possession is not essential to the validity of a sale or contract to sell.

399. Price. A sale without price is ineffectual. The price may be fixed or "fixable"—that is, the parties may agree on a definite basis for determining the price in the future—for example, the market price on a given day, or a price to be fixed by an arbitrator, umpire, or other third party. But a contract which provides that the parties are to agree on a price later is unenforceable, because the minds of the parties have not completely met. (For an example, see sec. 1506.) If a contract merely says nothing about price, the law presumes that the parties intend a reasonable price.

400. Existence of subject matter: "future goods." "Future goods" are goods which are not yet in existence, or which the seller does not yet own. Such goods, as stated, cannot be the subject of a present or executed sale (sec. 393). Future goods are included in the designation "unascertained" goods, which are distinguishable from "specific" goods in determining when title passes. (See secs. 409-411.)

401. Destruction of subject matter. The Uniform Sales Act provides that "where the parties purport to sell specific goods, and the goods without the knowledge of the seller have *wholly perished* at the time when the agreement is made, the agreement is void." Similarly, the Act provides that when there is a *contract to sell* specific goods, and subsequently, before the risk passes to the buyer, the goods *wholly perish*, without fault of either buyer or seller; the contract is thereby avoided.

Example: X, a New York dealer, buys twenty-five barrels of specially graded and packed apples from an Oregon producer, and resells them to Y under a contract specifying an agreed price on delivery at Y's place of business in New York. The apples were shipped to X from Oregon but (through no fault of either X or Y) were totally destroyed before reaching New York. Since title, at the time of loss, was still in X (the contract

having specified delivery to Y), the loss falls on X. Neither X nor Y has any claim against the other, the contract in such case being void.

In case of substantial *partial* destruction, the buyer may treat the contract as avoided, or he may insist on taking title to so much as has not deteriorated or been destroyed. In the latter event, he pays the full price if the sales contract is indivisible (sec. 397), or a proportionate price if the contract is divisible.

402. Statute of frauds. We have already noted (secs. 182 and 188) the provisions of the statute of frauds originally within the seventeenth section of the English statute, dealing with contracts for the sale of personal property. The expression "goods, wares and merchandise," as used in the statute, embraces all types of personal property, including intangibles, or *choses in action* (sec. 1054), as well as tangibles. It does not, however, include long term leaseholds, though these are also governed by the statute of frauds. (See sec. 1500, subd. d.)

Manufacturing contracts. A contract to manufacture and deliver a product, regardless of price, is not within the statute of frauds, being classed as a contract for work, labor and services (sec. 188).

B. Passing Title

403. Title *v.* possession. Title is ownership. It does not necessarily include possession, because one may have the ownership but not the right of possession; as when one pawns a ring. To "pass title" is to transfer ownership.

404. Bill of sale. A bill of sale is a written instrument transferring title to personal property. Such instrument is merely formal evidence of the title transfer. Title may be transferred without it.

405. Who may pass title. Ordinarily, only the owner can pass title. Hence if I lose my watch or a thief steals it, the finder or thief cannot pass title, even though he sells the watch to an innocent person for value. However, there are a number of situations where a vendor in wrongful possession, having neither title nor authority to sell, may nevertheless pass title. These are situations where, to quote the Uniform Sales Act, "the owner of the goods is by his conduct precluded from denying the seller's authority to sell." Such situations include, among others, the following:

(a) *Sale by agent or dealer apparently authorized to sell.* When the owner intrusts possession of goods to an agent or dealer apparently clothed with authority to sell or to a person whose common business it is to sell, such as a factor or commission merchant (secs. 545, subd. g, and 596), with instructions *not to sell* except upon prior approval, or subject to further directions, or upon some other condition, a sale by such agent contrary to instructions will not prevent title from passing to a purchaser in good faith and for value. This rule of law has been confirmed by statute in most of our states.

Example: The Personal Property Law in New York provides ("Factors act," sec. 43): "Every factor or other agent, entrusted with the possession of any bill of lading, custom-house permit, or warehouseman's receipt for the delivery of any merchandise, and every such factor or agent not having the documentary evidence of title, who shall be intrusted with the possession of any merchandise for the purpose of sale, or as a security for any advances to be made or obtained thereon, shall be deemed to be the true owner thereof, so far as to give validity to any contract made by such agent with any other person, for the sale or disposition of the whole or any part of such merchandise and any money advanced, or negotiable instrument or other obligation in writing given by such other person upon the faith thereof."

However, possession is only *prima facie*, not conclusive evidence of authority to pass title. Thus, the court has held that the owner of an automobile who delivered it to a motor company for sale on the owner's approval could recover it from one who purchased it from the company's salesman, who absconded with the proceeds.² Likewise, in a sale "on memorandum," the Court has refused to bar the owner's title as against an innocent third party purchaser.

Example: Green, a jeweller, gave Vollman, a dealer, an emerald cut diamond, which Vollman was to show his customers and sell, if possible, but only on prior approval by Green. Vollman confirmed this arrangement by a signed memorandum. He then passed the diamond on to another dealer, Cohn, who passed it on to still another dealer, Arnow, who sold it to two people named Wachs and Mann. The money paid for the stone never reached Vollman or Green. Green, standing on the signed memorandum and insisting that he was still the owner, sued Wachs and Mann for the return of the diamond. The court found for Green, holding that "even an innocent purchaser for value, such as these defendants, had no better right to the stone than did Vollman."³

(b) *Possession of documents or "indicia" of title.* When a person is intrusted with a negotiable document of title, such as a bill of lading or warehouse receipt calling for delivery to the order of a person whose name is indorsed on the document, or when a person is intrusted with any other evidences or "indicia" of title, such as a bill of sale or certificate of ownership, such person may pass title to an innocent purchaser in good faith and for value, though the documents or "indicia" were surrendered by the

² *Eatonville State Bank v. Marshall*, 170 Wash. 503, 17 P. 2d 14.

³ *Green v. Wachs*, 254 N.Y. 437.

holder contrary to the owner's instructions. The owner's only recourse in such case is against the custodian who violated instructions.

(c) *Sale by one having voidable title.* When a person acquires a chattel through fraud, his title is voidable, at the seller's option; but if, before the seller rescinds, the fraudulent buyer resells the chattel to an innocent purchaser for value, the latter gets good title notwithstanding the voidability of his vendor's title.

(d) *Duplicate sale of same merchandise.* A buyer of merchandise who leaves it with the seller risks a possible resale (deliberate or by mistake) to a second buyer who, if innocent of the facts, may acquire title as against the first buyer. (The seller in such case would be liable to the first buyer for conversion.)

(e) *Sale by conditional vendee.* Under a conditional sales contract (sec. 440), the seller transfers *possession* to the buyer, but retains *title* in himself pending final payment. If, in the meantime, the buyer resells the chattel, the second buyer acquires title as against the original owner, unless the latter has publicly filed the conditional sales agreement (sec. 442).

406. Purchaser in good faith and for value. To be a purchaser in good faith and for value, one must have made the purchase for a valuable consideration, and without knowledge, suspicion, or reason to know or suspect that the vendor's title was defective or the transaction irregular. However, if the vendor has no title at all, he cannot pass title, regardless of the purchaser's innocence, or the value paid. For example, when one buys for cash, which he does not pay, he fails to acquire even a voidable title; hence he cannot pass title even to an innocent purchaser for value.⁴

407. Importance of ascertaining when title passes. When goods in the process of sale are lost, damaged or destroyed, the loss falls on the owner unless the other party is to blame for it. If, at the time of loss, title has not passed, the loss falls on the seller as owner; if title has passed, the loss falls on the buyer as owner. Hence it is frequently important to determine at what point in the transaction title passes.

408. When title passes: general rule. Title passes when the parties intend it to pass. When parties fail to express their intention as to when title shall pass, it becomes necessary to invoke rules of law. These rules are prescribed by the Uniform Sales Act.

409. Specific *v.* unascertained goods. The Uniform Sales Act in prescribing rules as to when title passes in the absence of express agreement, distinguishes between *specific* and *un-*

⁴ *Packard Florida Motors Co. v. Malone*, 208 La. 1058, 24 So. 2d 75.

ascertained goods. *Specific* or *ascertained* goods are goods selected or set aside either by the buyer, or by the seller with the buyer's consent. *Unascertained* goods are goods not yet selected or in existence, such as a lot of 500 dresses ordered by the buyer subject to his selection, or a lot of 500 suits of clothes to be made up on specifications to be furnished by the buyer.

410. **Passing of title: specific goods.** The question as to when title passes to specific goods depends upon whether the goods are *in a deliverable state*.

(a) *Specific goods in deliverable state.* Under an unconditional contract to sell specific goods in a deliverable state, title passes when the contract is made, even though delivery or payment be deferred. If, however, delivery or payment is stipulated as part of the contract before the bargain is closed, title does not pass until such delivery or payment is made.

Example: The *M* Company, a boatbuilder, selected certain mahogany lumber in the *Y* Company's yard, and bought and paid for it. The *Y* Company agreed to load the lumber on a railroad freight car. Before the *Y* Company had the opportunity to do so, the lumber was destroyed by fire without the *Y* Company's fault. If delivery on board the freight car was stipulated *after* the contract was closed, the loss would fall on the *M* Company as owner, because title would have passed on the closing of the contract to sell specific goods in a deliverable state. If delivery on board the freight car was stipulated *before* the contract was closed, the loss would fall on the *Y* Company as owner, because title would not pass until such delivery was made. In either event, if the *Y* Company had loaded the lumber on the freight car before the fire occurred, the loss would have fallen on the *M* Company as owner.

(b) *Specific goods not in a deliverable state.* Title to specific goods not in a deliverable state passes when the goods are put into a deliverable state; for example, title to a machine which the seller has agreed to rebuild does not pass until the seller has rebuilt the machine.

(c) *Goods sold "on sale or return."* Title to goods sold "on sale or return" passes immediately, but may revert in the seller at the buyer's option exercised within the time fixed in the contract, or, if no time has been fixed, within a reasonable time.

Example: *A* buys goods from *B* on the understanding that *B* shall take back any goods unsold at the end of the season. If, during the season, the goods are destroyed by fire the loss falls on *A*, whether the fire occurred through *A*'s fault or not, since he was the owner when the fire occurred.

(d) *Goods sold on approval.* When goods are sold on approval, title passes when the buyer signifies his approval within the time agreed, or if no time has been agreed upon, within a reasonable time.

Example: In August, *A* delivers a secondhand roadmaking machine to *B* on approval. No time is fixed for its return if unsatisfactory. The machine having been neither paid for nor returned by the end of the year, *A*

sues *B* for the purchase price. Judgment would go for *A*. By failing to return the machine within a reasonable time, *B* signified his approval.

(e) *Fungible goods*. Fungible goods are goods consisting of a uniform mass, no part of which can be ascertained or sold except by weight or measure, such as peas, beans, oats, wheat, corn, barley, flour, wine, oil, gasoline, sand or bricks. Such goods, when sold by weight or measure, are deemed specific goods, and if they are in a deliverable state, title to them passes upon the making of the contract.

Example: *R* buys 400 bushels of corn out of a quantity of 4000 bushels owned by *M* and stored in a grain elevator. *R* pays for the corn and gets a receipt. He then gives the receipt to his agent, with an order on the grain elevator in connection with arrangements to ship the wheat the following morning. If, before the order is presented to the grain elevator company, the elevator and contents are destroyed by fire, the loss must fall on *R*, since he became the owner of the corn when the contract was made. The transaction was equivalent to a contract to sell specific goods in a deliverable state.

411. Passing of title: unascertained goods. In a contract to sell unascertained goods, title passes when the goods are ascertained and "unconditionally appropriated to the contract"; that is, when the goods are definitely set aside for the buyer, or selected, marked or designated, either by the buyer, or by the seller with the buyer's consent.

Example: A department store orders a quantity of razor blades from a jobber, with instructions that the store's trade name is to be imprinted on the blades. If, after such imprint is made, the blades are destroyed or damaged without the jobber's fault, the loss falls on the department store: title passed on the unconditional appropriation of the blades to the contract (by stamping).

Delivery. Though unconditional appropriation to the contract may take place without delivery, such appropriation is conclusively established when delivery actually takes place.

Delivery to a common carrier. Delivery to a common carrier is delivery to the buyer, because the carrier is deemed to be the *buyer's agent*, with the following exceptions: (1) when the buyer names a particular carrier and the seller ships by another; (2) when the seller is required by contract or custom to make actual delivery to the buyer; (3) when the seller is required to deliver at a particular place, as at the buyer's dock or railroad siding; (4) when the seller is required to pay the freight up to a given point, as in F.O.B. contracts; (5) when the seller is required by contract or custom to make arrangements with the carrier to protect the buyer (as by declaring the value of shipment, or as in "C.I.F." contracts), and fails to do so; (6) when the seller ships a larger or smaller quantity than that ordered; and (7) when the seller reserves title, as by retaining the bill of lading.

Goods sold by sample or description. When goods are bought by sam-

ple, or by description (as in the case of goods ordered from a catalog), title passes when goods of the description ordered or goods corresponding to the sample are unconditionally appropriated to the contract. (For an illustration, see sec. 1511, subd. c.)

412. F.O.B. shipments. When goods are shipped f.o.b. ("free on board") at a given point, such as the shipping point, or destination, or an intermediate point, the seller pays the cost of transportation up to that point, and the buyer from that point on; and title passes upon delivery to the carrier at the point specified. However, when goods are shipped f.o.b. shipping point, "sight draft, bill of lading attached, with the privilege of examining the goods on arrival," they are not unconditionally appropriated to the contract until payment or tender of the price.

413. C.O.D. shipments. The fact that a shipment is C.O.D. (cash on delivery) does not alter the rule that title passes upon delivery to the carrier: it merely requires payment before surrender of *possession*.

Example: A ships goods to B by carrier instructed not to deliver without payment. The carrier negligently delivers to B without payment. If B resells to C, a *bona fide* purchaser for value without notice, neither A nor the carrier can recover the goods from C. Title passed to B on delivery to the carrier. For violating the instruction not to deliver possession without payment, the carrier is liable to A.

414. C.I.F. shipments. The letters "c.i.f." mean "cost, insurance and freight." A c.i.f. contract is one for the sale and delivery of goods at a price to cover the cost of the merchandise, freight and insurance. Under a c.i.f. contract, title passes when the seller completes his contract. "Unless there is something in a c.i.f. contract to indicate to the contrary, the seller completes his contract when he delivers the merchandise called for to the shipper, pays the freight thereon to point of destination, and forwards to the buyer bill of lading, invoice, insurance policy, and receipt showing payment of freight."⁵

Example: A contract for the sale of antimony, to be shipped from Hamburg to New York, called for the following: (1) shipment—promptly from Hamburg, (2) duty—for account of buyers, (3) insurance—for account of sellers, (4) payment—net cash against shipping documents payable upon arrival of steamer, (5) no arrival, no sale. The shipment reached New York within the contract time. The invoice, freight receipt, bills of lading

⁵ *Seaver v. Lindsay Light Co.*, 233 N.Y. 273. To the same effect: *Smith Co., Ltd., v. Marano*, 267 Penn. St. 107.

and other documents were not forwarded by the seller to the buyer but were tendered to the buyer after the goods had arrived. The insurance policies were issued to bearer "for account of whom it may concern," and were never tendered to the buyer. The bills of lading were through bills and did not contain the name of the buyer as assignee. When the anti-mony arrived in New York, the buyer refused to accept it. In a suit for the price, the question was whether or not this was a true c.i.f. contract, under which title would have passed to the buyer on shipment at Hamburg. The Court, in reversing judgment for plaintiff in the Court below, held: "The finding that the instrument constituted a c.i.f. contract was a conclusion of law without evidence to support it. As title to the goods was not transferred, an action for the purchase price cannot be maintained * * *." ⁶

415. Auction sales. In an auction sale title passes when the hammer falls, unless the right is reserved, under the terms of sale, to determine whether the bid shall be accepted.⁷ Title passes with the falling of the hammer though the buyer is required to deposit secured notes before he can take the property away and has not done so.⁸ Hence, loss of goods sold at auction, but retained temporarily by the seller under arrangement with the buyer, falls upon the buyer, the seller being a mere bailee, and the sale having been completed.⁹

C. Warranties

416. Warranty defined. A warranty is a material statement of fact made by a seller, which induces a purchase. Applied to sales, it is not to be confused with the term *personal warranty*, or personal obligation to assume or pay another's debt.

Warranty v. representation. In a broad sense, every warranty is a representation, but not every representation is a warranty. A representation is an antecedent statement made to induce a sale or contract of sale; a warranty is part of the contract itself. A breach of warranty constitutes a breach of contract; a fraudulent representation constitutes a tort. See sections 130 and 1516.

* *Cundill v. A. W. Millhauser Corporation*, 257 N.Y. 419. In pointing out why the contract did not conform to c.i.f. requirements, the Court said: "The contract as written did not conform to the regular c.i.f. contract form. Under such a contract, the insurance should be for the benefit of the buyer as the title passes on shipment and the risk of the voyage is on the buyer. Here the provision of the contract was 'Insurance—For account of sellers.' The terms of the contract as to payment were also in conflict with the terms of a c.i.f. contract. The contract of sale reads: 'Payment—Net cash against shipping documents payable upon arrival of steamer.' * * *. So also the words, 'No arrival, no sale', are repugnant to the idea of a c.i.f. contract."

⁷ *City of New York v. Union News Co.*, 222 N.Y. 263, 118 N.E. 635.

⁸ *Forbes v. Hunter*, 223 Ill. App. 400.

⁹ *Stanhope State Bank v. Peterson*, 205 Iowa 578, 218 N.W. 262.

Warranty v. guaranty. A warranty is a statement made on behalf of one's self in connection with a sale or other transaction. A guaranty is an undertaking to answer for another's obligation, that is, to make it good if the other defaults (sec. 904).

Materiality. If the statement or representation was not material, that is, if it did not induce the purchase, it may be ignored.

Fact v. opinion. The statement must relate to a fact as distinguished from the seller's "boosting," "puffing," trade talk or other expression of opinion. (See sec. 1516, subd. b.)

Example: Cohen buys a used truck from Butts on the latter's assurances that the cylinders (1) have been rebored and (2) will give more power than a new car. Both statements prove untrue. "(1)" is a statement of fact, on which Cohen may return the truck and get his money back. "(2)" may be construed as a statement of opinion, on which, alone, Cohen may not be able to rescind.

Express warranty. Basically, an express warranty is one created by words, oral or written. The Uniform Sales Act defines it as follows: "Any affirmation of fact or any promise by the seller relating to the goods is an express warranty if the natural tendency of such affirmation or promise is to induce the buyer to purchase the goods, and if the buyer purchases the goods relying thereon."

Implied warranty. An implied warranty is one deducible from conduct or circumstances. A warranty may also be implied in law from considerations of public policy. The most common example is a *warranty of title*. Every person impliedly warrants that he owns what he sells, with the exception of goods sold at forced or judicial sales, such as executors', administrators', auctioneers' or sheriffs' sales. Other examples of implied warranties are those in sales by sample (sec. 418), description (sec. 419) and for a particular purpose (sec. 420).

Implied warranties which conflict with express warranties. An express warranty has the effect of excluding any implied warranties in conflict with it.

Example: An express warranty that "Gleamo" is guaranteed to impart a high polish to all brass surfaces without injury to the metal excludes an implied warranty that the polish will be equally efficacious and noninjurious when applied to silver.

However, an express warranty of quality is not necessarily inconsistent with an implied warranty of fitness.¹⁰

417. Warranty of quality: *caveat emptor v. caveat venditor.* The common law implied no warranties of quality. A person bought "as is," and took the risk as to the quality of what he bought. The doctrine applied was *caveat emptor*: Let the buyer beware. (See section 1517 for illustration.) As opposed to this doctrine of the common law was the civil law

¹⁰ *Greenland Development Corp. v. Allied Heat. Prod. Co.*, 184 Va. 588, 35 S.E. 2d 801.

(sec. 4) rule of *caveat venditor*: Let the *seller* beware: "A sound price implies a sound quality."

The *caveat emptor* doctrine still applies to ordinary sales, particularly those where the buyer has a full opportunity for inspection and where the parties deal at "arm's length." Especially in the case of defects which are obvious, not hidden, a buyer with full opportunity to inspect is bound by his bargain.

Exceptions to the caveat emptor doctrine. The Uniform Sales Act makes the following exceptions to the doctrine of *caveat emptor*, invoking, in effect, the doctrine of *caveat venditor* in such cases: (1) sale by sample, (2) sale by description, and (3) sale for a particular purpose.

418. Sale by sample. When goods are sold by sample, the seller impliedly warrants (a) that the bulk shall correspond with the sample in quality, (b) that the buyer shall have a reasonable opportunity of comparing the bulk with the sample, and (c) that if the seller is a dealer in goods of that kind, the goods shall be free from any defect rendering them unmerchantable which would not be apparent on reasonable examination of the sample.

419. Sale by description. When goods are sold by description, there is an implied warranty that the goods will correspond to the description.

Example: Smith orders a raincoat described in a mail-order catalog as handmade and waterproof. There is an implied warranty that the raincoat shipped will conform to that description.

420. Sale for particular purpose. When goods are sold for a particular purpose and the purpose is either made known by the buyer to the seller, or should be known by the seller from the nature and circumstances of the purchase, and *where the buyer relies on the seller's skill or judgment*, there is an implied warranty that the goods shall be reasonably fit for such purpose.

Food: fitness for human consumption. A person who sells food impliedly warrants that it is fit for human consumption¹¹ unless the food is boxed or packaged under some patent or other trade name, in which case the law holds that if the buyer calls for such package by trade name, he relies on his own judgment.¹² The implied warranty of fitness for human consumption applies only as between seller and buyer, not as between seller and a third party to whom the buyer resells.

¹¹ *Baum v. Murray*, 23 Wash. 2d 890, 162 P. 2d 801.

¹² *Botti v. Venice Grocery Co.* (Mass.), 35 N.E. 2d 491.

Example: A lunchroom waitress who bit into a nail baked into a cake sued the company which baked the cake. The suit was dismissed on the ground that the company warranted nothing as to a consumer with whom it had no direct dealing.¹³

Mechanical products. In purchasing mechanical products, buyers are prone to rely on the seller's skill and judgment, unless they make their own selection by brand or known make. In the former situation, buyers may rely on an implied warranty of fitness for the particular purpose intended; in the latter, not, since the buyer substitutes his own judgment for the seller's.

Examples:

(1) A certified public accountant, relying on a salesman's knowledge of the particular purpose for which it was intended, buys a calculating machine, after explaining such purpose. If the machine proves unfit for the purpose in question, the certified public accountant may rely on the implied warranty of fitness.

(2) A farmer buys (from a dealer) a "Challenge Tractor," which proves unfit for his purpose. Since he used his own judgment in selecting the make, he must stand on it.

D. Remedies

421. Seller's remedies. The seller's remedies against the buyer include: (a) lien; (b) stoppage in transit; (c) resale; (d) rescission; (e) action for the price; and (f) damages.

422. Seller's lien. A seller's lien is possessory, that is, it continues only so long as the seller retains possession, though he has parted with title. The lien cannot exist when *title* has not passed, since one cannot have a lien against his own property. In addition to possession, the requisites of such lien are: (a) goods sold without stipulation as to credit; or (b) goods sold on credit, but credit has expired; or (c) seller becomes insolvent. The seller may exercise his lien even when he is in possession as agent or bailee of the buyer.

Example: A sold a carload of paper to B on sixty days' credit and delivered a bill of sale, but for the convenience of the parties he kept the paper in his possession. B assigned the bill of sale to C a month afterward and then became insolvent. C demanded the paper of A who refused delivery on the ground of B's insolvency. Judgment for A. Though the credit had not yet expired, B's insolvency revived the lien.¹⁴

423. Stoppage in transit. Though the seller, upon delivery to a carrier, parts with possession, the law under certain conditions revives his possessory lien and gives him the right to

¹³ *Chysky v. Drake Bros. Co.*, 235 N.Y. 468.

¹⁴ 55 *Corpus Juris* 904, sec. 885 (citing numerous cases).

stop the goods in transit. The basis of this right is equity, which projects an equitable lien over goods no longer in the seller's possession, to prevent an insolvent buyer from getting something for nothing.

Conditions. The conditions for exercising the right of stoppage in transit are: (1) goods sold on credit, (2) insolvency of buyer, (3) goods still in transit.

Once the goods cease to be in transit and come into the buyer's actual possession, it is too late for stoppage in transit.¹⁵

Example: Jones sold a carload of lumber to Silsbee Company to be shipped f.o.b. destination, New Hartford, N.Y. The day before the lumber arrived the Silsbee Company was adjudicated a bankrupt and a receiver appointed. The receiver having taken possession of the lumber as an asset of the bankrupt, Jones was unable to recover it.¹⁶

"Ways of exercising the right to stop. The unpaid seller may exercise his right of stoppage in transitu either by obtaining actual possession of the goods or by giving notice of his claim to the carrier or other bailee in whose possession the goods are. Such notice may be given either to the person in actual possession of the goods or to his principal. In the latter case the notice, to be effectual, must be given at such time and under such circumstances that the principal, by the exercise of reasonable diligence, may prevent a delivery to the buyer."¹⁷

Notice by wire has been held sufficient.¹⁸

Duty of carrier; expense of redelivery. "When notice of stoppage in transitu is given by the seller to the carrier, or other bailee in possession of the goods, he must redeliver the goods to, or according to the directions of, the seller. The expenses of such redelivery must be borne by the seller."¹⁹ A carrier who delivers the goods in the face of a stoppage notice is liable to the seller for the consequent loss.

Example: A in Chicago sold goods to B in Boston and shipped them by express. While the goods were still in the express company's possession A, learning that B was insolvent, notified the express company to return the goods to A, but the express company, upon payment of the express charges, delivered the goods to B. For consequent loss, A may hold the express company.

Duty when negotiable document of title issued. If the carrier has issued a negotiable or order bill of lading (sec. 509), or if a bailee (such as a storage warehouse) has issued a warehouse receipt, such carrier or bailee "shall not be obliged to deliver or justified in delivering the goods to the seller

¹⁵ *Henderson Co. v. Webster*, 178 Ark. 553, 11 S.W. 2d 463; *Weyerhaeuser Timber Co. v. First Nat. Bank*, 150 Or. 172, 38 P. 2d 48.

¹⁶ *In re Arctic Stores*, 258 Fed. 688.

¹⁷ Uniform Sales Act, sec. 59, subd. (1).

¹⁸ *Interstate Window Glass Co. v. New York, N.H. & H.R. Co.*, 104 Conn. 342, 133 A. 102.

¹⁹ Uniform Sales Act, sec. 59, subd. (2).

unless such document is first surrendered for cancellation.”²⁰ Criminal penalties may attach for so doing. (See section 1520, subd. c.)

Example: Rummell & Co. sold A & Co. on credit 500 cases of varnish which they had stored in Blanchard’s warehouse. They delivered the warehouse receipt to A & Co., who became bankrupt before calling for the varnish or paying for it. Rummell & Co. thereupon demanded the varnish of Blanchard, who refused to give it up except upon surrender of the warehouse receipt. In a suit by Rummell & Co., the court sustained Blanchard.²¹

The provision abridging stoppage in transit when a negotiable document of title has been issued is intended for the benefit of innocent purchasers for value; hence neither the insolvent buyer nor an assignee for the benefit of creditors can take advantage of it.

Example: Park sold goods to Markoe, shipped them by express, and forwarded a negotiable bill of lading to Markoe. While the goods were in transit Markoe, being insolvent, made an assignment of his property, including the bill of lading, to Good as assignee for the benefit of creditors. Park, learning the facts, stopped the goods in transit. Park’s rights, as against Good’s claim, will be sustained: Good was not an innocent purchaser for value. Park may reclaim the bill of lading, and upon surrendering it, recover the goods.

424. Resale. When the seller exercises his right of lien or of stoppage in transit, he may resell the goods in any of the following situations:

- (a) When they are of a perishable nature;
- (b) When the seller expressly reserves the right of resale in case of the buyer’s default;
- (c) When the buyer has defaulted in payment for an unreasonable time.

The Uniform Sales Act provides²² that upon such resale, the seller “shall not thereafter be liable to the original buyer upon the contract to sell or the sale or for any profit made by such resale, but may recover from the buyer damages for any loss occasioned by the breach of contract or the sale.”

425. Rescission. There are two kinds of rescission: absolute and qualified. To rescind a contract absolutely is to treat it as if it had never existed, so that no rights or claims survive it: The seller has no cause of action against the buyer for damages, and resumes title and possession as if he had never parted with them. In qualified rescission, the seller likewise resumes title and possession, but he does not rescind the entire con-

²⁰ Uniform Sales Act, sec. 59, subd. (2).

²¹ *Rummell & Co. v. Blanchard*, 216 N.Y. 348.

²² Section 60, subd. (1).

tract, because he reserves the right to hold the buyer for any loss resulting from his default.

426. Action for price. When the seller has transferred both title and possession, he is in no position to assert a lien, stop goods in transit, or resell them; neither is rescission effective as a remedy. He must therefore sue for the purchase price.

427. Damages for nonacceptance. When the buyer wrongfully neglects or refuses to accept and pay for the goods, the seller may maintain an action against him for nonacceptance. The measure of damages, as defined by the Uniform Sales Act, is "the estimated loss directly and naturally resulting in the ordinary course of events, from the buyer's breach of contract." Ordinarily, when there is a market for the goods, this means the difference between the market and the contract price at the time of the breach. The seller must "mitigate," not "aggravate" damages (sec. 240) after notification of nonacceptance. He may include prospective profit.

428. Seller's alternative remedies. A seller often finds himself in a position where he may resort to one of several alternative remedies. For example, suppose an ice dealer sells 7000 tons of ice to a buyer, who agrees to pay for and remove it by a given date. Two months prior to such date, the buyer notifies the seller that he will not take the ice. The seller is now faced with a choice of alternative remedies:

- (a) He may await performance date and, upon the buyer's refusal to take delivery then, sue for the price (sec. 426).
- (b) He may treat the buyer's notification as an anticipatory breach (sec. 237) and sue for damages for nonacceptance (sec. 427).
- (c) Having a seller's lien for the unpaid price, he may exercise his right of resale (sec. 424).
- (d) For the same reason (seller's lien), he may rescind the transaction (sec. 425).

429. Protecting sale through shipping documents. When shipping goods to a purchaser, the seller may retain title in himself until the purchase price is paid, by drawing a bill of exchange on the buyer for the price and transmitting it with the bill of lading to a bank or other agent for collection. On payment of the bill of exchange, the bill of lading is delivered. Or the seller may send both bill of exchange and bill of lading direct to the purchaser, with the understanding that delivery of the bill of lading is conditional only, and is not to be deemed

absolute until the bill of exchange is paid. When the purchaser pays the bill of exchange, the conditional delivery of the bill of lading becomes absolute, and title thereby passes automatically to the buyer. "Where the seller of goods draws on the buyer for the price and transmits the bill of exchange and bill of lading together to the buyer to secure acceptance or payment of the bill of exchange, the buyer is bound to return the bill of lading if he does not honor the bill of exchange, and if he wrongfully retains the bill of lading he acquires no added 'right thereby.'"²³

430. Fraudulent transfers. A transfer of one's property is fraudulent if its object is to cheat someone and its intent to avoid some obligation of the party making the transfer. Among the tests to determine whether a transfer is fraudulent are: (a) good faith of transaction, (b) prejudice to creditors, (c) intent, (d) existence and sufficiency of consideration, (e) relationship between transferor and transferee.

Seller retaining possession after sale. When the seller, after an absolute sale, retains possession of the merchandise without valid reason, such retention is presumed to be fraudulent. If the fraud is established, judgment creditors (sec. 73) may have the alleged transfer set aside and the property applied to the payment of their judgments.

Fraudulent or preferential transfers while insolvent constitute acts of bankruptcy (sec. 1293) and may be set aside by the trustee in bankruptcy. When a document of title is transferred during solvency but the property itself is retained and not transferred until later when the transferor is insolvent, such transfer is fraudulent as to creditors.

Example: A stockholder, while solvent, executes and delivers to his wife, as a gift, a bill of sale for the stock, but retains the stock certificate and continues to vote the stock until three years later when, being insolvent, he indorses the stock certificate to his wife without consideration, and has it transferred to her on the books of the corporation. Such transfer is void. Under the Uniform Stock Transfer Act, title to stock can be transferred only by delivery of the certificate. Hence, the bill of sale is ineffective to transfer the stock in any event. Regardless of such requirement, however, the husband's retention of the certificate and voting privileges makes the transfer presumably fraudulent as to creditors. The subsequent actual transfer of the certificate does not cure the situation, because it was made while the husband was insolvent.

431. Bulk sales. Many of our states have adopted statutes designed to prevent dishonest merchants from buying up large quantities of merchandise without paying for it and then selling it to third parties and making off with the proceeds. The

²³ Uniform Sales Act, sec. 20, subd. (4).

New York "Bulk Sales Act" is similar to others. It provides that sales in bulk are void against creditors unless the following requirements are observed:

(a) The seller, at least ten days before the sale, must make and deliver to the purchaser a full and detailed inventory showing each article to be included in the sale, and, so far as possible, its cost price to the seller.

(b) The buyer must retain this inventory in his possession for at least ninety days thereafter, subject to inspection by any creditor of the seller.

(c) The buyer must demand and receive from the seller a written list of names and addresses of the seller's creditors, with the amount of indebtedness due to each of them; and the seller must certify this list under oath to be a full, accurate and complete list of his creditors and of his indebtedness.

(d) At least ten days before taking possession of or paying for the merchandise or fixtures sold, the buyer must notify each creditor personally or by registered mail of the proposed sale, giving the price, terms and conditions of the sale.

The statute further provides that any purchaser of such merchandise who fails to conform to the above requirements shall, upon application of any of the seller's creditors, be deemed to hold the merchandise as a receiver and shall be accountable for it to such creditors.

Similar laws are now on the statute books in reference to chattel mortgages placed on goods in bulk, or on merchandise and fixtures used in the conduct of a person's business. (See sec. 1161, "Fraudulent chattel mortgages.")

432. Buyer's rights and remedies. A buyer's rights correspond to the seller's duties, and his remedies are designed to ensure performance of those duties. It is the seller's duty (a) to deliver the goods at the agreed time and place, or, if no time or place is agreed upon, within a reasonable time and at the seller's place of business or residence, or wherever the goods are; and (b) to make good all warranties, express or implied. The buyer's remedies include: (a) conversion, (b) breach of contract for failure to deliver, (c) specific performance, and (d) breach of warranty.

433. Conversion. When the seller has passed title but wrongfully refuses to deliver possession, the buyer may sue him for conversion (sec. 29); the seller has no right to keep what belongs to the buyer.

434. Breach of contract for failure to deliver. Whether title has passed or not, the buyer may sue the seller for damages

for failure to deliver. The *measure of damages* is "the loss directly and naturally resulting in the ordinary course of events" from the seller's breach. Ordinarily, when there is a market for the merchandise, this means the difference between the contract price and the market price at the time of the breach (delivery date).²⁴

Seller's failure to give instructions. When shipments are to be made upon the buyer's instructions and the buyer fails to give instructions, he cannot cancel the contract because of the seller's failure to deliver.

Example: Kent agreed to sell and deliver 200,000 yards of sheeting to be manufactured by Iselin, and Silberstein agreed to take four monthly deliveries of 50,000 yards each beginning in September. The contract contained the words "shipping instructions later." No delivery having been made in September, Silberstein cancelled the contract. Kent, claiming that he had notified Silberstein of readiness and willingness to deliver, but that Silberstein had failed to give shipping instructions, sold the goods in the open market for Silberstein's account, at a loss of \$12,765.77, for which he sued Silberstein. The court gave judgment to Kent: Silberstein, having failed to give shipping instructions, could not cancel the contract for failure to ship.²⁵

Failure to deliver right chattel. A failure to deliver a particular chattel ordered is equivalent to a failure to deliver. A buyer is entitled to get what he buys; he need not accept a substitute.

Example: Defendant, a coffee importer, contracted to sell all his discarded bags to plaintiff, after repacking the coffee in other containers. Without plaintiff's knowledge or consent, defendant, retaining his own bags, bought substitutes and resold them to plaintiff at a profit. This would not be a compliance by defendant with the contract: Regardless of whether the other bags were similar or "just as good," plaintiff was entitled to get the particular bags ordered. To recover damages, however, plaintiff would have to prove that bags similar to those ordered cost plaintiff more on the open market.

Failure to deliver right quantity. When the seller delivers a *larger quantity* than ordered, the buyer may (1) reject the entire shipment, or (2) accept the right quantity and reject the rest, or (3) accept the entire shipment at the contract rate. When the seller delivers a *smaller quantity* than ordered, the buyer may (1) reject the entire shipment or (2) accept the shorter shipment and sue for damages resulting from failure to deliver the right quantity.

Periodic deliveries. When the seller fails to make periodical deliveries in full as agreed, but eventually makes up the shortages by subsequent over-shipments which are accepted by the buyer, the latter cannot counterclaim for damages resulting from the previous short shipments, because by ac-

²⁴ *Consolidated Pipe Line Co. v. British American Oil Co.*, 163 Okl. 171, 21 P. 2d 762.

²⁵ *Kent v. Silberstein*, 241 N.Y. 440.

cepting the short shipments in the first place without objection, he waived any damage he might have sustained because of the shortages.

Example: Under a contract calling for periodic deliveries of coal, *K* sued *Y* for failure to take an undelivered balance. *Y* counterclaimed because *K* had failed to make certain periodic deliveries in full as per contract, though the shortages were later made up. The counterclaim was dismissed. *Y*, by failure to protest the shortages, and by accepting subsequent overages to balance the shortages, had waived any damages due to previous failure to deliver the right quantity.²⁶

435. Specific performance. This remedy is applied only in special cases. See section 242.

436. Breach of warranty. For breach of warranty, the buyer is given any one of the following optional remedies:

(a) Accept or keep the goods and set up against the seller the breach of warranty by way of recoupment in diminution or extinction of the price.

(b) Accept or keep the goods and maintain an action against the seller for damages for the breach of warranty. The measure of damages in such case is the same as in the case of a seller's failure to deliver (sec. 434).

(c) Refuse to accept the goods, if title has not passed, and maintain an action against the seller for damages for the breach of warranty.

(d) Rescind the contract to sell, or the sale, and refuse to receive the goods, or if the goods have already been received, return or offer to return them to the seller and recover the price or any part of it which has been paid.

Election and waiver of remedies. When the buyer has claimed and been granted a remedy in any one of these ways, he will be deemed to have waived the other remedies.²⁷

Example: Smith contracted to sell and deliver at Jones' place of business, by truck delivery on a given date, certain goods of specific quality. At the time and place in question, the goods were delivered and paid for. On that date, the market price of the goods was substantially higher than the contract price. The next day Jones examined the goods, found them to be not as specified, returned them, notified Smith that he rescinded the contract, and replaced the goods by others bought in the open market. Jones then sued Smith to recover the price, plus the additional sum paid in buying on the open market. Such suit would have to be dismissed: Having elected option (d) above, Jones waived option (b).

437. Right to examine goods. The Uniform Sales Act makes the following provisions in respect to the buyer's right to examine the goods:

(a) *Right to examine before delivery.* Unless otherwise agreed, when the seller tenders delivery of goods to the buyer, he is bound, on request, to afford the buyer a reasonable opportunity of examining the goods for

²⁶ *Wm. C. Atwater & Co. v. Panama & Co.*, 255 N.Y. 496.

²⁷ *Yancey v. Jeffreys*, 39 Ariz. 563, 8 P. 2d 774.

the purpose of ascertaining whether they are in conformity with the contract.

(b) *Right to examine goods after delivery.* When goods, which he has not previously examined, are delivered to the buyer, he is not deemed to have accepted them unless and until he has had a reasonable opportunity to examine them for the purpose of ascertaining whether they are in conformity with the contract.

(c) *C.O.D. shipments.* On C.O.D. shipments, the buyer is not entitled to an examination before paying the price, unless otherwise specifically agreed. "When the agreement of purchase is that the buyer will pay the purchase price by sight draft to be attached to the bill of lading, he is not entitled to an inspection of the property before paying the draft, and he cannot refuse to accept the property because such inspection is refused."²⁸ A similar rule would apply when the contract calls for acceptance of a time draft on delivery.

Example: Early in August the A Company, in New York, accepted a draft payable September 1 in favor of the B Company, of Norway, against a shipment of cod-liver oil. The oil when tested (the testing process took ten days) proved to be of lower grade than that specified. The A Company notified the B Company by cable of the defects, offered to return the oil, and on September 1 refused to pay the draft (which was still held by the B Company). The B Company refused to accept a return of the oil and sued for the price, claiming that the A Company had accepted the oil. The B Company's position would be sustained, since the transaction called for draft acceptance on delivery, which constituted a waiver of the right of examination before acceptance. However, such waiver would not bar an action by the buyer for damages notwithstanding acceptance (sec. 438).

438. Damages notwithstanding acceptance. The Uniform Sales Act provides that unless otherwise agreed, the buyer's acceptance of the goods does not discharge the seller from liability in damages or other legal remedy for breach of warranty (sec. 436) unless he fails to notify the seller of the breach within a reasonable time after discovery.

E. Conditional Sales²⁹

439. Installment buying and conditional sales. The tremendous growth in our industrial output has been made possible

²⁸ *Plumb v. J. W. Hallauer*, 145 App. Div. 20.

²⁹ There is considerable diversity in the statutory provisions governing conditional sales. The rules herein summarized are based largely on the provisions of the Uniform Conditional Sales Act adopted by the states as shown in the table on pages 12-13. At the National Conference of Commissioners on Uniform State Laws in August, 1943 the Uniform Conditional Sales Act was withdrawn from the active list of Uniform Acts recommended for adoption, pending preparation of the Uniform Commercial Code. In the meantime, however, it represents the law in force in the states which have adopted it and is substantially the law in many other states.

by installment selling. This in turn has been made possible by such legal devices as conditional sales and chattel mortgages,³⁰ which enable the sellers of merchandise to part with possession yet retain title as security, while the buyer gets immediate use but is not required to make immediate payment of the full price. In an ordinary sale on terms requiring subsequent payments of stated amounts at stated intervals (such as thirty, sixty, ninety and 120 days after delivery), title passes to the buyer, and if the payments are not made, the seller must sue for the price. Often as not the seller in such case gets an uncollectible judgment. In a conditional sale, however, the seller retains title until fully paid. The thing sold stands as security; it may not be resold to a third party until paid for, if the seller has filed the sales agreement as required by law; and it may be retaken by the seller if the buyer defaults in his payments.

440. Conditional sale defined. The Uniform Conditional Sales Act defines a conditional sale as any contract for the sale of goods under which possession is delivered to the buyer and title is to vest in him subsequently upon the payment of part or all the price, or upon the performance of any other condition, or the happening of any other contingency.

Parties to conditional sale. The seller and buyer under a conditional sale are frequently referred to, respectively, as *conditional vendor* and *conditional vendee*.

441. Conditional sale *v.* lease with option to purchase. Frequently a seller desiring to avoid the statutory restrictions governing conditional sales and imposed for the protection of the buyer, gives the transaction the appearance and effect of a lease with an option to purchase. The Uniform Conditional Sales Act, however, in defining a conditional sale, includes "any contract for the bailment or leasing of goods by which the bailee or lessee contracts to pay as compensation a sum *substantially equivalent to the value of the goods*, and by which it is agreed that the bailee or lessee is *bound to become*, or *has the option of becoming* the owner of such goods upon full compliance with the terms of the contract."³¹

442. Filing conditional sales agreement. A conditional vendor should file the conditional bill of sale or a copy of it, else

³⁰ Chattel mortgages are discussed in section 1161.

³¹ Sec. 1.

an innocent third party who buys the chattel from the conditional vendee may acquire good title as against the conditional vendor. It is not necessary for the document to be "recorded," that is, to be copied into permanent record books (as in the case of deeds and mortgages).

Example: Brown sells a television set to Green for \$500; terms, \$50 down, balance, \$50 monthly; title retained until final payment. Green, after the initial payment, resells the set for \$100 to White, who believes Green to be the true owner. Green disappears. If Brown has complied with the law in respect to filing, he may reclaim the set from White; otherwise not.

443. Risk of loss or injury. Ordinarily, damage to, or loss or destruction of a chattel must be borne by the owner. However, under the Uniform Conditional Sales Law, a conditional vendor's title is regarded as nominal only, for the protection of the seller. If a chattel is lost, damaged or destroyed while in the conditional vendee's possession, the loss is borne by the conditional vendee.

444. Removal or sale without notice. A conditional vendee may neither remove the chattel from the filing district where he bought it, nor sell his interest in the conditional sales contract, without first giving the seller written notice of the proposed removal or sale. If he does, the seller may retake the chattel and exercise the same remedies as if the conditional vendee had defaulted in one of the payments.

445. Fraudulent injury, concealment, removal or sale. The preceding section relates to innocent removal or the sale of his interest by a conditional buyer. If the buyer, before discharging the contract, maliciously or with intent to defraud injures, destroys or conceals the goods, or removes them to a different filing district without written notice to the seller, or sells or mortgages the goods under the pretense that he is the full owner, he is guilty of a crime and subject to fine and imprisonment.

446. Retaking possession. If the buyer defaults in any of the payments, the seller may retake possession of the goods. Unless the goods can be retaken without breach of the peace, they must be retaken by legal process.

447. Buyer's right to redeem. Although there is considerable diversity of statutory provision on the subject, in states which have adopted the Uniform Conditional Sales Act the

buyer has a right to redeem the goods unless the seller, before retaking, gave the buyer (a) advance notice of his intention to retake and (b) an opportunity to make good the default before the retaking, and the buyer failed to make good notwithstanding. If the buyer did not receive such notice, he has ten days after the retaking within which to redeem, by making good the default plus expenses of retaking.

448. Resale after retaking. Under certain conditions, resale by the seller after retaking is compulsory. If the buyer (having a right to do so) does not redeem the goods within ten days after the retaking, and if he has paid in at least half the purchase price at the time of retaking, the seller *must* sell the goods at public auction after posting public notice and giving the buyer written notice of the sale. If the buyer has not paid in at least half the purchase price at the time of retaking, he has ten days after the retaking within which to serve a written request, personally or by registered mail, demanding a resale, in which event a resale, upon public notice and notice to the buyer, must be had.

449. Proceeds of resale: deficiency. The proceeds of the resale must be applied (a) to payment of the expenses of the sale, (b) to payment of the expenses of retaking, keeping, and storing the goods and (c) to satisfaction of the balance due under the contract. Any surplus remaining must be paid to the conditional buyer. If there is a deficiency, the seller may recover it from the buyer.³²

Example: Laufer sold furniture to Burghard for \$515.39 on conditional sale. After default, with \$343 remaining due, Laufer retook possession of the furniture and resold it. (a) If the net proceeds amounted to \$400, Laufer must account to Burghard for \$57, less expenses of sale, retaking, and so on. (b) If the net proceeds amounted to \$200, Laufer need not account to Burghard for any of the proceeds and may recover the deficiency from Burghard.

450. Rights of parties when there is no resale. When resale is not compulsory, the seller may retain the goods as his own property without obligation to account to the buyer. When resale is required but not held, the buyer may recover his actual damages from the seller, and in no event less than one fourth of the sum of all his payments, with interest.

³² Statutory amendments in some states have softened these provisions in the case of small purchasers in noncommercial transactions.

F. Trust Receipts

451. Origin and nature. The general nature of a trust receipt has already been indicated (sec. 285). Its use is not new: Businessmen have used trust receipts in financing imports for half a century. The practice has been for the foreign seller to draw a draft on the importer's banker for the purchase price, accompanied by order bills of lading (sec. 509) covering the merchandise. The importer's banker thereupon met the draft, took title to the bills of lading as security, and delivered possession to the importer for a special purpose only, such as to reship, to store, to process, or to sell for the purpose of paying off the banker's advance. The importer, on receiving the bills of lading from the bank, then signed a trust receipt acknowledging that title remained in the banker, and agreeing to limitations embodied in the trust receipt restricting the importer's rights in connection with the goods.

In more recent years, the use of trust receipts has been extended to the financing of installment sales of automobiles, refrigerators, radios, and so on. Manufacturers, or finance companies and banks on their behalf have developed the practice of financing dealers' purchases and taking trust receipts to cover advances on the purchase price.

The absence of filing and other statutory requirements seemed to give trust receipts an advantage over conditional sales and chattel mortgages. The popularity of trust receipts grew, and in the course of time the practice developed of stock-brokers and others borrowing securities and negotiable paper from banks to be used as collateral or for purposes of effecting collection; the borrower delivering trust receipts to the lender as evidence that the latter retained title.

The use of trust receipts in lieu of conditional sales and chattel mortgages, and the question of how far trust receipts, without public filing, were binding upon innocent third parties as against the rights of the lender, gave rise to conflicting decisions which resulted in the formulation of a Uniform Trust Receipts Act adopted by twenty-one states.³³

³³ California, Connecticut, Idaho, Illinois, Indiana, Maryland, Massachusetts, Minnesota, Montana, Nevada, New Hampshire, New Jersey, New York, North Dakota, Oregon, Pennsylvania, South Dakota, Tennessee, Utah, Virginia and Washington.

Questions and Problems for Review

1. Distinguish between a sale of goods and a contract to^fsell. The statute of frauds prescribes that a contract or sale of goods above a certain minimum value shall not be enforceable by an action at law unless one or more requirements are met. List the requirements. *NY Nov. 1934 (3)*

2. On the 31st day of October, 1930, an agreement was entered into by which Mr. Bacon, among other things, agreed to deliver 36,000 tons of iron ore to the Bay Iron Company, for which the company agreed to pay Mr. Bacon in pig iron, at the rate of one ton of pig iron for every eight tons of ore delivered. Was this a contract to sell? Give reason. *NY Nov. 1931 (14)*

3. Illustrate divisible contract of sale. *NY Nov. 1929 (3)*

4. What essential elements enter into a sale of personal property? *NY Jan. 1922 (13)*

5. X, a New York dealer, purchased twenty-five barrels of specially graded and packed apples from a producer at Hood River, Oregon. These apples he afterwards resold to Y under a contract which specified an agreed price on delivery at Y's place of business in New York. The apples were shipped to X from Oregon but, through no fault of either X or Y, were totally destroyed before reaching New York. Is there any liability resting upon X? *AI May 1921 (5)*

6. What are "goods, wares and merchandise" within the meaning of the statute of frauds? *AI Nov. 1918 (Contr 4); NY Nov. 1932 (2)*

7. What is the provision of the statute of frauds with respect to sales of goods, wares and merchandise? *AI June 1917 (2)*

8. What is a bill of sale? *AI Nov. 1928 (8)*

9. Can a vendor, in wrongful possession, convey good title to property? Explain. *NY Jan. 1922 (14)*

10. Miller, a diamond cutter, gave a diamond on memorandum to Falk, the written memorandum expressly providing that title was to remain in Miller until Miller approved of a sale by Falk. Falk, representing that he was the owner and without showing the written memorandum, sold the diamond to Porter for cash and then disappeared without accounting to Miller. Miller now sues Porter to recover possession of the diamond. For whom should judgment be rendered? *AI Nov. 1933 (3)*

11. Samuel Jones, an operator in oil properties, deposited in his bank his stock in several oil companies, taking from the bank a trust receipt for the stock, which stood in Smith's name but was indorsed in blank. Sixty days after such depositing of the stock, Smith, who

had a claim against Jones for an unpaid account, filed an attachment with the bank against the stock deposited. However, between the date of depositing the stock and the date of filing such attachment, Jones had assigned certain of these shares to other persons, and had notified the bank of certain transfers, but the bank had not accepted the transfer, and for reasons sufficient to itself had refused to issue new trust receipts to the transferees. Can these new transferees force the bank either to deliver the stock to them or to issue new trust receipts in their favor? *NY Jan. 1923 (6)*

12. When was a sale complete so as to pass title at common law, and how did the statute of frauds and perjuries change this? *AI May 1918 (11)*

13. The *M* Company, a boatbuilder, selected certain mahogany lumber in the *Y* Company's yard and bought and paid for it. The *Y* Company agreed to load the lumber on a railroad freight car to be placed on the siding in its yard. Before the *Y* Company had the opportunity to do so, the lumber was destroyed by a fire which was not due to any fault of the *Y* Company. On whom does the loss fall? *AI May 1930 (7)*

14. Assume that in question 7* the *Y* Company had loaded the lumber on the freight car and had consigned the car to the *M* Company, but before the car was started on its journey fire had destroyed the car and its contents. Would there be any responsibility different from that developing from the conditions given in question 7 and, if so, why? *AI May 1930 (8)*

15. *A* sold a carload of paper to *B* on sixty days' credit and delivered a bill of sale, but for the convenience of the parties he kept the paper in his possession. *B* assigned the bill of sale to *C* a month afterward and then became insolvent. *C* demanded the paper of *A* who refused delivery on the ground that *B* had become insolvent. Is *A*'s contention correct? If not, why not? *NY June 1916 (7)*

16. In order to induce a customer to buy a larger quantity of merchandise than the customer considered it judicious to purchase, Smith & Company agreed with the purchaser to take back any goods remaining unsold at the end of the season. Shortly after the delivery of the goods by Smith & Company they were totally destroyed by fire, for which fire the purchaser was in no way responsible, nor was he derelict in the care of the merchandise. By whom must this loss be borne? *NY June 1919 (11)*

17. In August, 1928, *B* delivered on approval to *P*, a secondhand roadmaking machine, no time being fixed for its return, if unsatisfactory. The machine neither being paid for nor returned by *P* by December 31, 1928, *B* sued *P* to recover the purchase price of \$500.00. Will he succeed? Give reasons. *NY May 1928 (12)*

18. On August 11, 1921, C. N. Russell bargained with John

* This refers to the previous question (No. 13).

McCarty for the purchase of 400 bushels of corn, being part of about 4000 bushels then owned by McCarty and stored in a certain grain elevator. The price was agreed upon, paid by Russell to McCarty and receipt therefor given. In addition McCarty gave Russell an order directed to the elevator company directing it to deliver 400 bushels of corn to Russell. Russell gave the order to his agent with directions to deliver it to the captain of a certain steamship expected to arrive the next day to take the 400 bushels of corn on board. The next morning before the arrival of the steamship and the presentation of the order to the elevator company, the elevator and contents were destroyed by fire. Russell afterwards brought suit to recover the purchase price from McCarty. What would be your decision on such suit? *AI Nov. 1921 (7)*

19. *A* sold goods to *B* and shipped them by a common carrier, to be delivered to *B* upon the payment of the purchase price. Through the negligence of the carrier, *B* obtained possession of the goods without paying for them and sold them to *C*, a bona fide purchaser for value without notice. Can *A* or the carrier recover the goods or their value from *C*? *AI May 1931 (9)*

20. State when title passes in each of the following cases:

- (a) Sales f.o.b. place of shipment.
- (b) Sales f.o.b. destination.
- (c) Sales f.o.b. place of shipment, "sight draft, bill of lading attached, with the privilege of examining the goods on arrival."
- (d) Buyer orders goods and writes, "Deliver to any common carrier, addressed to me I also agree to pay the cost of transportation."
- (e) C.O.D. shipments. *NY Nov. 1931 (4)*

21. A contract, signed by the seller and accepted in writing by the buyer, contained the following matter:

New York, Jan. 2, 1932

To A. W. Jones Corp.,
2 Broadway, New York, N.Y.

Dear Sirs:

Herewith we confirm sale to you for the account of ourselves, through C. S. Smith & Co.: 25 tons (each 2240 lbs. net) Chinese Antimony Regulus, 99%, @ 21¾¢ per lb., c.i.f. New York.

Shipment—Promptly from Hamburg.

Duty—For account of buyers.

Insurance—For account of sellers.

Payment—Net cash against shipping documents payable upon arrival of steamer. No arrival, no sale, but proof of shipment to be given by sellers.

At the time this contract was signed, the goods were in transit between China and Hamburg. The shipment arrived in Hamburg and was transshipped to New York. The shipment reached New York within the contract time. The invoice, receipt for freight,

bills of lading, and other documents were not forwarded by the seller to the buyer but were tendered to the buyer after the goods had arrived. The insurance policies were issued to bearer "for account of whom it may concern" and were never tendered to the buyer. The bills of lading were through bills of lading and did not contain the name of the buyer as assignee.

(a) What does "c.i.f." mean?

(b) Is this contract a c.i.f. contract? *AI May 1932 (3)*

22. Define personal warranty in a sale of personal property. *NY Jan. 1918 (5)*

23. Cohen bought a used truck from Butts on the statement by Butts that all the cylinders had been rebored and would give more power than a new car. This statement was untrue. Cohen offers to return the truck and demands his money back. Will Cohen succeed? Explain your answer. *NY May 1931 (15)*

24. Define an express warranty. *AI May 1921 (7)*

25. What does a seller impliedly warrant in the sale of a chattel? *AI Nov. 1917 (7)*

26. What general rule of contract law is embraced in the term *caveat emptor*? *AI Nov. 1922 (6)*

27. Jones decides to purchase a tractor for use on his farm. The George Tractor Company manufactures and markets a tractor under the trade name of "Challenge Tractors." Jones purchases a "Challenge Tractor" but after about two weeks' use he finds that it is not of sufficient power for his work because his farm is largely soft muck land used for raising market vegetables. He seeks to return the tractor and the George Tractor Company seeks to recover an unpaid balance of the purchase price. Which of them will succeed? *AI May 1930 (2)*

28. On August 1, 1932, an ice company by a valid contract sold 7000 tons of ice to Whitney, who agreed to pay for and remove it by November 1, 1932. On September 3, 1932, Whitney, who had paid no part of the purchase price, notified the ice company that he would not take the ice. What remedies has the ice company? *AI May 1933 (6)*

29. What is the right of stoppage in transitu? What three conditions are necessary to give the seller this right? *NY May 1931 (10)*

30. In what ways may the seller of goods, wares and merchandise exercise his right of stoppage *in transitu*? *NY Apr. 1933 (4)*

31. Define "stoppage in transit," state who may exercise this right, and in general when the right ceases to exist. *AI Nov. 1934 (11)*

32. *A* in Chicago by written instrument contracted to sell to *B* in New York certain goods, with the provision that the goods were

sold f.o.b. the Pennsylvania Railroad at Chicago, payment to be made sixty days after delivery. *A* delivered the goods to the Pennsylvania Railroad at Chicago, took the bill of lading in the name of *B* and forwarded it to *B*. Before the goods arrived at New York, *A* learned that *B* had become insolvent. Has title to the goods been vested in *B*? What are *A*'s rights? *AI May 1920 (6)*

33. *A*, in Chicago, sold certain goods to *B* in Boston. The goods were shipped to *B* by express. After shipment, and while the goods were in the possession of the express company, *A* ascertained that *B* was insolvent and unable to pay for his purchase. *A* notified the agent of the express company at Boston, in whose custody the goods were, to withhold delivery to *B* and to return the goods to *A*. The goods were, however, delivered to *B* upon his payment of the express charges. *A* sued the express company for conversion. Could he recover? *AI May 1922 (6)*

34. Your client sold a carload of lumber to Sillsbee Company to be shipped f.o.b. New Hartford, New York, the point of destination. The day before the lumber arrived, the Sillsbee Company was adjudicated a bankrupt, and a receiver was appointed. The receiver took possession of the lumber as an asset of the bankrupt. Can your client recover this lumber or its value in cash from the receiver or trustee? If so, on what grounds? *NY May 1931 (5)*

35. *R & Co.* sold *A & Co.* on credit 500 cases of varnish which *R & Co.* had stored in the warehouse of *X*. *R & Co.* delivered the negotiable warehouse receipts therefor to *A & Co.*, who thereafter became bankrupt before the varnish was paid for. *R & Co.* sue *X* to compel *X* to return the varnish to them. Will they succeed? Give reason. *NY May 1929 (13)*

36. Park sold certain goods to Markoe, shipping them by express and forwarding a negotiable bill of lading therefor to Markoe. Markoe was insolvent and while the goods were in transit he made an assignment of his property, including the bill of lading, for the benefit of his creditors. Park, on being advised of the facts and before the goods were delivered, exercised a right of stoppage in transitu by proper notice to the express company. Markoe's assignee claimed the goods by reason of holding the bill of lading, maintaining that the transfer to him of the document ended Park's right of stoppage in transitu. To whom should the goods be awarded? *AI Nov. 1929 (12)*

37. Under the Uniform Sales Act, what are the remedies of the seller when the buyer refuses to accept the goods contracted to be sold? *AI Nov. 1922 (7)*

38. How may a seller ship goods to a purchaser, retaining title in himself until the purchase price is paid? How is title then passed when the purchaser makes payment? *AI May 1927 (2)*

39. *K* agreed to sell and deliver 200,000 yards of sheeting to be

manufactured by *I*, and *S* agreed to accept delivery of the goods. The price was 22 cents per yard, delivery to be made at *I*'s mill, 50,000 yards each in September, October, November and December, 1925. The contract contained the words "shipping instructions later." *K* had the goods manufactured by *I* according to the agreement and had them ready at *I*'s mill for delivery at the rate of approximately 50,000 yards each in September, October, November and December, 1925. *S* was notified that the goods were ready for shipment and delivery, and *K* offered to deliver them according to the contract, but *S* refused to give shipping instructions for the goods, and failed and refused to receive them and to pay the agreed price. *K* thereafter and on notice to *S* sold the goods in the open market for the account of *S* at a loss to *K* of \$12,765.77, for which sum *K* sues *S*. For whom will judgment be given? Give reasons. *NY Nov. 1927 (15)*

40. Under the Uniform Sales Law what remedies may the buyer invoke, at his election, for breach of warranty? *AI Nov. 1921 (5)*

41. The *A* Company, a New York corporation, made a contract with the *B* Company in Norway for its yearly supply of Norwegian cod-liver oil of certain specifications. Payments for oil were to be made by drafts. A shipment of 200 barrels arrived in New York early in August, the *A* Company accepting a draft for the purchase price payable September 1st and taking the oil from the steamer to its plant. The oil when tested (the testing process requiring about ten days' time) proved to be of lower grade than required by the specifications. The *A* Company notified the *B* Company by cable of the defects, offered to return the oil to the *B* Company and refused to pay the draft on September 1st (the draft being still held by the *B* Company). The *B* Company refused to accept a return of the oil and sued for the purchase price claiming that the *A* Company had accepted the oil. Did the *A* Company have a defense? *AI Nov. 1924 (5)*

42. *K*, as plaintiff, sues *Y*, as defendant, for failure to take deliveries of certain quantities of coal remaining undelivered under the terms of a written agreement entered into between plaintiff and defendant.

At numerous times *K* failed to make deliveries in full of the agreed upon periodical deliveries, but eventually made up such shortages by subsequent overshipments which were accepted by *Y*.

Y counterclaims for damages resulting from previous short shipments. *K* contends that *Y* has waived all right to damages for such breach.

Decision for whom, and why? *NY Oct. 1933 (15)*

43. Smith contracted to sell to Jones certain goods of specific quality to be delivered by truck to Jones' place of business on March 10, 1925. On that date Smith delivered the goods and Jones paid for them. At the date of delivery the goods were of considerably

higher market value than the price under the contract. The next day Jones found that the goods were not as specified. He, Jones, then returned the goods, notifying Smith that he rescinded the contract, and replaced them by purchasing other goods in the open market. Jones subsequently sued Smith to recover the amount he had paid to Smith and also the amount he had been compelled to pay above the contract price in order to purchase in the open market. What did Jones recover? *AI May 1925 (7)*

44. Sanborn in June, 1928, while entirely solvent, executed and gave to his wife as a gift a formal bill of sale of his interest in the Mann Drug Corporation, in which he owned 110 shares of stock, but he retained the stock certificate, the stock was not transferred on the books of the corporation, the corporation was not notified of the bill of sale, and Sanborn continued to vote on the stock and receive dividends until April, 1931. At that time he was hopelessly insolvent and knew it, but without receiving any consideration he indorsed the certificate for these 110 shares to his wife, who had the transfer recorded on the corporation's books. Was this transfer of stock fraudulent as against Sanborn's creditors? *AI Nov. 1931 (4)*

45. What is the difference between the contract called *installment lease* and one under which merchandise is sold on terms requiring payments of stated amounts in thirty, sixty, ninety and one hundred and twenty days after delivery? *AI May 1919 (7)*

46. (a) What is a conditional sale and how does it differ from a lease with an option to purchase?

(b) How in general can a conditional vendor protect his rights? *AI Nov. 1931 (8)*

47. What constitutes a conditional sale of personal property? Is an unrecorded contract of this nature valid as against subsequent purchasers or pledgees? *NY June 1919 (5)*

48. Laufer sold furniture to Burghard on a conditional sales contract for the sum of \$515.39. The furniture was delivered and installments were collected until the balance due on the contract was \$343. Thereupon Laufer lawfully retook possession of the furniture and sold it. Must Laufer account to Burghard for any portion of the proceeds of the resale,

(a) if the net proceeds amounted to \$400?

(b) if the net proceeds amounted to \$200? *AI May 1933 (3)*

CHAPTER V

Bailments and Carriers

452. Scope of chapter. In this chapter we consider the nature, essentials and classifications of bailments, and the rights, duties and obligations involved in business transactions constituting bailments for mutual benefit, such as pledges, the hire of chattels and the hire of service. In the latter category we consider contracts for alteration and repair, the rights and duties of warehousemen and of innkeepers, and the rights, duties and obligations involved in the hire of transportation, known as the law of carriers. In summarizing the latter, we distinguish between carriers of goods and carriers of passengers, initial and connecting carriers and interstate and intrastate carriers, with a brief reference to the rules of law applicable to each. We also touch on some legal principles applying peculiarly to common carriers by water, with an indication of some of the provisions for the regulation of carriers by various governmental agencies, Federal, state and municipal.

A. Nature and Essentials

453. Bailment defined: parties. A bailment of goods is the delivery and acceptance of personal property for some particular purpose, upon condition that the property be redelivered when it has served its purpose, or that it be kept until reclaimed, or that it be otherwise dealt with according to agreement.

The persons concerned in a bailment of goods are the *bailor*, who delivers the chattel, and the *bailee*, who accepts it.

454. Essentials of bailment. Three elements must be present to give rise to a bailment:

(a) *A valid existing chattel.* No rights can arise out of an illegal bailment. Thus, an attempt by the owner to reclaim forbidden narcotics or illegally purchased food or drink stored in a warehouse will receive no legal support. Also, there can be no bailment of future goods (sec. 400).

(b) *Transfer of possession.* Unless the owner transfers possession, there can be no bailment. Giving custody to an employee does not constitute transfer of possession: The employee's possession is the employer's possession. Transfer of possession may be actual, as by delivery of the thing itself, or constructive, as by delivery of a bill of lading, warehouse receipt or the key to a store.

(c) *Acceptance.* Delivery without acceptance is insufficient to constitute a bailment.¹

Examples:

(1) During your absence, I leave a package on your doorstep with a note asking you to deliver it to the postman. If the package is stolen before you return, you incur no liability: Without your acceptance, no bailment arose.

(2) Some jewelry left in clothing sent to the cleaners got into the hands of employees who, without the cleaner's knowledge, made off with it. As to the jewelry, there was no acceptance by the cleaner, and no bailment.²

(3) Swindlers ordered goods from a manufacturer to be sent to a dealer; then telephoned the dealer in the manufacturer's name that the goods had been sent by mistake and would be called for; then called for and disappeared with the goods. In dismissing a suit by the manufacturer against the dealer, the court held that there was no real delivery and acceptance, hence no bailment.³

(4) Plaintiff hung up his overcoat on a hook in the box of a theatre occupied by him while watching a performance. The overcoat disappeared. Plaintiff sued the proprietor of the theatre. *Held*, for the proprietor. No real acceptance or delivery can be presumed from these facts.⁴

(5) A customer enters a clothing store and waits on himself. Knowing that there is no one but himself to watch his garment, he lays it aside while trying on new ones. His garment is lost. The proprietor is not liable. There was no bailment—no delivery and acceptance.⁵

(6) A customer took off her cloak and, there being no other place to put it, laid it on a counter directly in front of a clerk who was waiting on her with a cloak in her hands for the customer to try on. While she was trying on the cloak, her own cloak disappeared. *Held*, that there was an implied acceptance by the clerk of the customer's cloak as a bailment.⁶

In addition to the foregoing elements, every bailment contract must have the usual contract requisites.

455. Bailments distinguished from similar transactions. Bailments are distinguishable from sales, exchanges, gifts, con-

¹ *Wells v. West*, 212 N.C. 656, 194 S.E. 313; *Panhandle South Plains Fair Ass'n v. Chappell*, Tex. Civ. App., 142 S.W. 2d 934.

² *Copelin v. Berlin Dye Works*, 168 Cal. 715.

³ *Krumsky v. Loeser*, 37 Misc. 504.

⁴ *Pattison v. Hammerstein*, 17 Misc. 375.

⁵ *Wamser v. Browning King & Co.*, 187 N.Y. 87.

⁶ *Bunnell v. Stern*, 122 N.Y. 539.

ditional sales and the consignment of goods to a factor or commission merchant, as follows:

Bailment v. sale. A bailment transfers possession alone; a sale transfers title, with or without possession.

Bailment v. exchange. Although exchanges are embraced within the law of sales (sec. 394), the nature of an exchange gives it a closer resemblance to a bailment. The distinction has already been pointed out (sec. 395). If the identical thing transferred is to be returned in the same or altered form, the transaction is a bailment; otherwise, an exchange.⁷

Examples: Wilson, a miller, contracted to take wheat of Harvey and to return one barrel of flour for every five bushels of wheat. After the wheat was delivered but before delivery of the flour, the mill burned down without Wilson's fault. Harvey sued for the value of the flour. The court, in granting judgment for Harvey, pointed out that the wheat, when destroyed, was Wilson's, since the transaction was an exchange, not a bailment. The contract called for flour against wheat, not flour to be milled from Harvey's wheat.⁸

Bailment v. gift. Although both a bailment and a gift require transfer of possession, in the case of a bailment, title remains in the transferor, whereas in the case of a gift, title passes to the transferee.

Bailment v. conditional sale. Bailments in the form of leases with an option to purchase, and the circumstances under which they are or are not classed as conditional sales, are discussed in section 441.

Bailment v. consignment. Although goods on consignment constitute a bailment until they are sold, an ordinary bailment differs from a consignment in two respects: (1) A bailment ordinarily involves the delivery and acceptance of a chattel for some particular purpose, the chattel to be returned to the owner in the same or altered form when it has served the purpose. A consignment does not contemplate a return of the goods, but their sale to third parties by the consignee and an accounting for the proceeds of the sale. (2) Since a bailment contemplates possession, whether for safe keeping, or as a pledge, or for use by the bailee, or for some service to be rendered (such as repairs, storage or transportation), there is no ostensible authority to sell, and an unauthorized sale by the bailee, even to an innocent third party for value, will not deprive the owner of his title. In a consignment, on the other hand, since the primary object is to sell, an innocent third party purchaser for value gets good title as against the owner even if the consignee, such as a factor or commission merchant, was instructed not to sell until further notice, or to sell only upon certain terms, which were violated.

Bailment v. trust. See section 1216.

B. Classification of Bailments

456. Common law classifications. The common law classified bailments as follows:

⁷ *Schindler v. Westover*, 99 Ind. 395.

⁸ *Norton v. Woodruff*, 2 N.Y. 153.

(a) *Depositum*, or a delivery of goods to be kept for the bailor *without recompense*.

(b) *Mandatum*, or delivery of goods for the purpose of having some service performed in respect to them *without charge*.

(c) *Loan*, either in the form of a *commodatum*, or gratuitous loan of goods to be temporarily used by the bailee and returned in identical form, or else in the form of a *mutuum*, which is a delivery of goods not to be returned in identical form, but to be replaced by other goods of the same kind (hence not really a bailment, but an exchange).

(The above bailments, it will be noted, are all without reward.)

(d) *Pignus*, in the nature of a pawn or pledge to secure some debt or obligation.

(e) *Locatio*, or a bailment for reward.

457. Modern classification. The modern classification of bailments is based on benefit to the parties, the first two being gratuitous, the third not:

(a) *Bailments for the sole benefit of the bailor*, as where the bailee gratuitously keeps something for the bailor, or renders some gratuitous service in connection with the bailor's chattel.

(b) *Bailments for the sole benefit of the bailee*, as where the bailor gratuitously lends something to the bailee.

(c) *Bailments for mutual benefit*, which are further classified and described in sections 470 to 492.

C. Rights, Duties and Obligations Common to All Bailments

458. In general. Certain rights, duties and obligations are common to all bailments, namely: (a) the bailee's duty to fulfill the purpose of the bailment, (b) the bailor's duty to deliver a safe chattel, (c) the bailee's right and duty to protect the chattel, and (d) the bailee's duty to return the chattel.

459. Bailee's duty to fulfill purpose of bailment. One who undertakes a bailment, whether gratuitously or for reward, must fulfill its purpose.

Example: If I leave a dog with you on your promise to take care of him in my absence, I can hold you liable for any damage I sustain in case you abandon the dog while I am away. This is true even where you get no benefit from the transaction: My sacrifice in parting with possession in reliance on your promise is the consideration which supports your promise (sec. 146). However, if I have not yet parted with possession, I cannot hold you to your *gratuitous* promise to take care of the dog, should you change your mind.

460. Bailor's duty to deliver safe chattel. Whether he receives any benefit or not, if a person lends or leases a chattel

to another for some purpose, the chattel must be safe. If it is not, and the bailee suffers damage in consequence, the bailor is liable.

Example: A contract for the leasing of an airplane provided that the plane was to be used exclusively for civil pilot training. The court held that this imposed a corresponding duty on the bailor to ensure that the plane was safe, suitable and airworthy.⁹

However, a bailor for mutual benefit is in this respect held to a stricter responsibility than a gratuitous bailor. The former is liable for not disclosing defects of which he knew *or should have known*; the latter only for defects actually known to him.

461. Bailee's right and duty to protect chattel. The bailee not only has the right but the duty to protect the bailment against damage, loss, theft or destruction.

Duty to insure. Because the bailee is charged with the responsibility of returning the chattel, he has an "insurable interest" (sec. 948) in it. However, a mere gratuitous promise to insure, unconnected with the liability or responsibility of a bailee, will not render one liable for loss through failure to insure. But if a gratuitous bailee agrees to insure a bailment, as part of another transaction which was supported by consideration, he is liable to the bailor if loss results from failure to insure the chattel; and this, even if the bailment be gratuitous.¹⁰

Examples:

(1) *A* and *B* were joint owners of a vessel. *A* voluntarily undertook to get the vessel insured, but neglected to do so. The vessel having been lost at sea, it was held that no action would lie against *A* for the nonperformance of his promise, although *B* had relied on that promise to his loss, because there was no consideration for the promise.¹¹

(2) Plaintiff had purchased furniture from defendant. Being about to leave the city, he arranged to send his furniture to defendant's storehouse where defendant agreed to keep it free of charge. There was evidence that while the furniture was still in plaintiff's possession, defendant's employee promised to insure the furniture for plaintiff's benefit. The Court held that the promise was part of the whole transaction and was linked up with the gratuitous bailment. When a bailee voluntarily undertakes a bailment without charge, he assumes the duty to take care of the goods; and when, in connection with such duty thus voluntarily assumed, he also voluntarily agrees to insure the goods, he is liable for a failure to effect such insurance even though the promise to insure was in itself without consideration.¹²

Duty to take legal steps. Likewise, though not the owner of the chattel,

⁹ *Dufort v. Smith*, 37 Luz. L. Reg. Rep. (Pa.) 315.

¹⁰ *Lazar v. Cohen*, 127 N.J. Law 310, 22 A. 2d 414.

¹¹ *Thorne v. Deas*, 4 Johns. 84, 99.

¹² *Siegl v. Spear & Co.*, 234 N.Y. 79.

the bailee may sue third parties who seek to appropriate, damage or interfere with it in any way.¹³

462. Bailee's duty to return chattel. A bailee must return the chattel to the bailor when it has fulfilled the purpose of the bailment. Failure to do so, upon the bailor's demand, subjects the bailee to a suit for *conversion*, or for *replevin*. These terms have already been defined. As applied to the law of bailments, conversion takes place when the bailee unlawfully retains or uses the bailment. For example, if a bailee to whom is entrusted possession of property belonging to another, sells such property, or uses it contrary to the terms of the bailment, he commits conversion. Similarly, when the bailee redelivers the property *to the wrong person*, even though he does so in good faith and without negligence, he commits conversion.¹⁴

D. Rights, Duties and Obligations Dependent upon Nature of Bailment

463. Particular rights, duties and obligations. In addition to the foregoing rights, duties and obligations common to all bailments, the following rights, duties and obligations depend upon whether the bailment is (a) for the sole benefit of the bailor, (b) for the sole benefit of the bailee, or (c) for mutual benefit:

- (1) Degree of care a bailee must use.
- (2) Bailee's right to use bailment.
- (3) Duty to reimburse bailee for expenses.
- (4) Right to terminate bailment.

464. Bailee's duty to exercise care. Regardless of degree, a bailee must exercise some measure of care in connection with the bailment. Failure to exercise care is negligence. If a bailment is lost, damaged or destroyed without negligence or fault on the bailee's part, the bailee is not liable, except where he is an "insurer" of the goods.

Example: A hires a "Drive-Your-Self" automobile at \$1.00 an hour. Through no fault of his, the car is damaged in collision with B. Since the damage occurred without A's fault, A is not liable for such damage. (Note: If B was negligent, he would be liable to the owner for damage to the car, and to A for any damage to him as bailee.)

¹³ *Grand Rapids & I. Ry. Co. v. Resur*, 186 Ind. 563, 117 N.E. 259.

¹⁴ *Baer v. Slater*, 261 Mass. 153, 158 N.E. 328; *Doyle v. Peerless Motor Car Co. of New England*, 226 Mass. 561, 116 N.E. 257.

465. When bailee is liable as insurer. For a consideration or "premium," one may contract to assume the role of insurer, that is, one may agree to be liable regardless of negligence. In addition, the law itself, as a matter of public policy, fixes the responsibility of an insurer on certain classes of persons, that is, it renders them liable regardless of negligence in connection with property in their custody. Examples are innkeepers (sec. 491) and carriers of goods (sec. 501).

466. Degree of care a bailee must use. A bailee must use either slight, great or ordinary care, depending upon the nature of the bailment. †

(a) *In a bailment for the sole benefit of the bailor*, the bailee, who is merely accommodating the bailor, is required to exercise but *slight care*, hence is liable only for *gross negligence*.

(b) *In a bailment for the sole benefit of the bailee*, the latter is being accommodated, hence he must exercise *great care* and is liable for *slight negligence*.

(c) *In a bailment for mutual benefit*, neither party is being accommodated. The bailee must exercise ordinary care and is liable for ordinary negligence.

What constitutes gross, slight or ordinary negligence depends on the facts of each case. The following examples may be illustrative:

(1) When a watch is left at a shop for repair, and the same night the shop is destroyed by fire, the shop owner's liability will depend upon whether, from the facts, he exercised ordinary care.

(2) If a bank accepts from a customer, for safekeeping, a package of money and securities, and the package is stolen by the bank's cashier who has previously had a good reputation, the liability of the bank will depend upon whether, from the facts, it exercised ordinary care.

(3) *A*, as security for a loan, gives *B* a watch, which *B* puts in his safe. If burglars break into the safe and remove its contents, *B*'s liability for the watch will depend upon whether the facts spell out lack of ordinary care, that is, ordinary negligence. •

(4) If, in example (3) above, the watch had been placed in a trunk instead of a safe, and removed therefrom by burglars, a court might well hold that *B* had exercised less than ordinary care, and was liable. If, however, *B* were a gratuitous bailee, a jury might find that *B* had exercised the "slight" care required of such bailee.

(5) *A* gave *B* a bag of gold coins to keep for him as an accommodation. *B* placed the bag of coins with his own money in a locked trunk, whence it was stolen by burglars. *Held*, that *B*, as a gratuitous bailee, exercised the degree of care required of him.¹⁵

¹⁵ *Hargis v. Spencer*, 254 Ky. 297, 71 S.W. (2nd) 666.

(6) In *More v. Fisher*,¹⁶ the court held that where a truck was used by a cleaner to pick up and deliver articles of clothing, it was lack of ordinary care to leave the truck unguarded in a public street in Chicago, even though it was locked and left for not more than five minutes.

(7) Jones, on an automobile trip from New York to Boston, agrees to take a valuable parcel for his friend Smith and to deliver it to Smith's son in Providence. Jones stops at Bridgeport for dinner, parks his car at the curb, takes his own property out, but leaves Smith's parcel in the car, whence it is stolen. Although Jones is a gratuitous bailee, a jury might well find that he failed to exercise the slight care required of him, that is, that he was grossly negligent, hence liable.

(8) Zindle, a jeweler, gave Mrs. Chapman, a prospective customer, a diamond brooch worth \$5200, to wear on trial. Mrs. Chapman wore the brooch with other expensive pieces of her own jewelry, to all of which she gave what women of her social standing regarded as reasonable care. Nevertheless, the brooch was lost or stolen. Since this was a bailment for mutual benefit (prospective purchase), and ordinary care was exercised, Mrs. Chapman was not liable for the loss.

(9) Brown, a farmer, borrows a team of horses from his neighbor. One of the horses steps into a hole in Brown's pasture and is lamed. Though Brown might not have been liable had he hired the use of the team, the fact that the bailment was for his sole benefit should have made him exceptionally careful, and a jury might well hold that he was guilty of slight negligence and liable accordingly.

467. Bailee's right to use bailment. The bailee's right to use the bailment is as follows:

(a) *In a bailment for the sole benefit of the bailor*, the bailee has no right to use the bailment unless use will not affect it, or is necessary to preserve it.

Example: Reading a book will not affect it; exercising a horse or milking a cow is necessary to preserve such bailment.

(b) *In a bailment for the sole benefit of the bailee*, use by the latter is naturally permitted, since it is the object of the bailment. But if the bailee uses the bailment for a different purpose than that agreed upon, he is liable to the bailor for any loss, damage or destruction to the bailment, though it occurred without his fault.

Example: If a person borrows a car to move his trunk, then uses it for a short pleasure trip, he is liable if the car is damaged on the pleasure trip, though the accident is not his fault.

(c) *In a bailment for mutual benefit*, use by the bailee depends upon the purpose of the bailment. For example, a musician who rents a piano to practice on it is in a different position from a warehouseman who merely stores the piano and has no right to use it.

468. Duty to reimburse bailee for expenses. In a bailment for the sole benefit of the bailor, the bailee is entitled to reim-

¹⁶ 245 Ill. App. 567.

bursement for any reasonable expense he incurs in accommodating the bailor by keeping the bailment for him. In a bailment for the sole benefit of the bailee, or for mutual benefit, the bailee may compel reimbursement only for extraordinary, not ordinary expense. If a contractor, for example, leases a drilling machine, he must bear the expense of replacing any drills he breaks, but not of replacing essential parts of the machine that require replacement through no fault of his own.

469. Bailee's lien: right to terminate bailment. The subject of liens is discussed in Chapter XIII. A bailee's lien is his right to retain possession of the bailment until some charge or obligation in connection with it is discharged or satisfied. (See section 1138.) The right to terminate a bailment, or to assert a lien in respect to it, depends upon the nature of the bailment.

(a) In a *bailment for the sole benefit of the bailor*, the latter may at any time require the return of his chattel, and the bailee may at any time require the bailor to take it back, unless the bailee has undertaken to keep the chattel for a prescribed period. The bailee has no claim or lien in connection with the bailment, since he undertook it without reward.

(b) In a *bailment for the sole benefit of the bailee*, since the bailor receives no value for the use of his chattel, nor consideration for his promise to let the bailee use it, he may require the bailee to return the chattel at any time; and of course the bailee has no lien in connection with it.

(c) In a *bailment for mutual benefit*, the rights of the parties, including the right to terminate the bailment, depend upon their contract and the type of bailment it creates. For example, in a pledge (sec. 471) or hire of service (sec. 480), the purpose of the contract would be defeated and the rights of the bailee infringed if the bailor could terminate the bailment at will. Moreover, when a bailee renders service in connection with a chattel, he acquires a *possessory lien* in respect to it. (See section 1531, subd. b.)

E. Mutual Benefit Bailments

470. Further classification of mutual benefit bailments. Bailments for the mutual benefit of bailor and bailee may take one of the following forms:

- (1) Pledge
- (2) Hire of use
- (3) Hire of service, including
 - (a) Labor, skill and materials
 - (b) Custody
 - (c) Transportation.

471. Pledge defined: essentials. A pledge is the bailment of personal property as security for the discharge of an obligation.

Examples:

- (1) Pawn of watch to secure loan.
- (2) Deposit of stocks or bonds as collateral security on a note.

The essentials of a pledge are: (a) an obligation to be secured, (b) the parties, *pledgor* and *pledgee*, (c) the thing pledged, (d) transfer of possession, (e) a contract, express or implied, governing the pledge, (f) reservation of title in the pledgor, and (g) the pledgor's right of redemption.

472. Pledge distinguished from chattel mortgage. A pledge differs from a chattel mortgage in at least three respects:

(1) *Nature of security.* The security of a pledge is *possessory*, whereas the security of a chattel mortgage lies in its character as a "charging lien" (sec. 1143), which does not depend upon possession. Thus, in a pledge, possession is in the obligee or creditor as security, the obligor or debtor retaining title. In a chattel mortgage, possession is usually in the mortgagor or debtor, the mortgagee or creditor retaining title, not possession, as security for the debt.

(2) *Necessity of public notice, by filing.* The pledgee's possession is sufficient notice that he claims some right in respect to the pledge. A chattel mortgage, however, is a charging lien: The creditor, in lieu of possession, must file the lien in a prescribed public place if he wishes to give public notice of his rights.

(3) *Rights on default.* In the case of a pledge, nonpayment or default does not work an automatic forfeiture; title remains in the pledgor until the pledgee, by selling the goods (on notice to the pledgor or not, as the contract may provide), divests the pledgor of title. In the case of a chattel mortgage, nonperformance causes an automatic forfeiture, that is, the mortgagee's title, reserved as security, becomes absolute.

473. Pledge distinguished from liens generally. A pledge is limited to the security afforded by possession. Liens are broader; they may extend to situations not dependent upon possession (sec. 1143). In the case of a pledge, transfer of possession is the object of the pledge. In the case of a lien, transfer of possession is an incident, not an objective: Possession is transferred for some purpose other than security, such as for alteration, repair, storage or transportation; the lien arising incidentally in case the service rendered is not paid for.

474. Common types of pledge: pawn and collateral. Among the more common illustrations of pledge are (a) the *pawning*

of chattels, and (b) the deposit of stocks and bonds as *collateral security*.

Although a "pawn" is technically synonymous with a pledge, the term is commonly used in relation to the pledge of chattels with a pawnbroker as security for a loan.

A pawn is clearly distinguishable from a deposit of securities as collateral in that the very thing pawned must be returned when it is redeemed, whereas the identical securities pledged as collateral need not be returned upon redemption (sec. 476).

Pawnbrokers. Pawnbrokers lend money on the deposit of chattels as security. Because they frequently deal with the financially unfortunate, their business is strictly regulated by statute. A pawnbroker cannot conduct his business without a license, must give bond, keep prescribed records (for police and other purposes), issue receipts against chattels pledged, and charge no more than a fixed interest rate. Pawnbrokers are prohibited from buying secondhand articles offered as pledges, and from selling the chattels of defaulting pledgors unless they remain unclaimed for at least a year and then only at public auction after published notice.

Collateral security. Technically, *collateral security* is any form of pledge accompanying and securing a debt. By common usage, the term has come to mean stocks and bonds deposited to secure a debt. (See section 1539.)

Income on collateral security belongs to the pledgor, but it may be collected by the pledgee and applied to reduction of the debt (sec. 1539).

475. How stock is pledged. A pledge of stock is usually made by depositing the stock certificate with the pledgee, duly indorsed in blank by the pledgor. Such indorsement consists of the pledgor's signature to an assignment, which usually carries with it a power of attorney delegating authority to transfer the stock on the books of the corporation. The assignment and power of attorney may be either printed, typewritten or hand written on the back of the certificate itself, or it may be executed on a separate paper attached to the certificate, known as a *fly-power*, which has the same effect as an indorsement on the back of the certificate.

476. Pledgee's right to sell or repledge stock. Pledgees of stock (usually stockbrokers) are customarily empowered by law to sell or repledge stock pledged with them to secure advances on margin transactions. (See section 1540.) The pledgee need not return the identical stock certificate or certificates deposited by the pledgor or customer. A bank, for example, need not retain for return to a borrower the identical

securities it receives as collateral, so long as it has on hand, at all times, an equivalent quantity of the securities pledged to answer the borrower's redemption (sec. 1533).

Pledgee's right to assign or repledge his interest. Unless prohibited by the terms of the pledge, a pledgee may assign or repledge his interest (sec. 1538).

477. Bonds deposited as pledge *v.* bonds deposited for safe-keeping. If a person deposits bonds with a bank as collateral for a debt, and also bonds for safekeeping, and the debtor defaults, the bank cannot apply, in satisfaction of the debt, the bonds deposited for safekeeping, even though the bonds deposited as collateral are insufficient to cover the debt. A deposit of bonds for safekeeping constitutes a special deposit, which cannot be set off against a depositor's indebtedness.¹⁷

478. Procedure on pledgor's default. The pledgee's procedure on the pledgor's default may be prescribed by the terms of the pledge. Otherwise, it is prescribed by law, including the requirement of a public sale on notice, the disposition of any surplus, and the pledgor's liability for a deficiency.

Rights of third parties. A *pledgor's creditor* may proceed against the property pledged, to the extent of the pledgor's interest; that is, to the extent of his right of redemption. Such creditor may pay the debt secured by the pledge and then levy upon the property. A *pledgee's creditor* may proceed against the pledged property only to the extent of the pledgee's possible interest in case of the pledgor's default; that is, his remedy is limited to the pledgee's remedy of selling the chattel upon the pledgor's default subject to the terms of the pledge.

479. Hire of use. When one rents a chattel, such as a car, a printing machine or a typewriter, he hires the use of it. The bailor or lessor, in such case, warrants that the chattel leased is fit for the purpose for which it is hired. If it is not, the bailor is liable for resulting loss sustained by the bailee. The bailee, on the other hand, must exercise reasonable care in the use of the chattel; he must pay, for such use, the rental agreed upon, or, in the absence of an agreed rental, the reasonable value of the hiring; and he must return the chattel in the same condition as it was in when the hiring commenced—reasonable wear and tear excepted.

480. Hire of service: in general. As noted in section 470, the hire of service includes (a) *labor, skill and materials ap-*

¹⁷ *First-Mercer Nat. Bank of Harrodsburg v. Tewmeyer's Assignee*, 246 Ky. 139, 54 S.W. 2d 672.

plied to a bailment, as when a bailor delivers raw materials for manufacture by a bailee, or a watch to be repaired by a jeweler, or a motor by a mechanic; (b) *custody*, as when valuables are left with a safe deposit company, or merchandise with a warehouse, or personal belongings with an innkeeper; and (c) *transportation*, which is more fully considered in relation to the law governing *carriers* (secs. 493 to 538 inclusive).

481. Hire of service: labor, skill and materials. When the bailee adds or uses material in the manufacture or repair of a chattel, such material becomes parts of the chattel, and title to it immediately vests in the bailor. For example, if a garageman installs new cylinders in an automobile, title thereto automatically vests in the bailor, and the garageman cannot thereafter remove the cylinders, even though he is not paid for his services. His proper remedy is to assert his lien by retaining the automobile as a whole. But if the chattel in question is made up *completely of materials furnished by an artisan or manufacturer*, there is really no bailment; as where a tailor makes up a suit of clothes, or a sculptor erects a monument, in both cases from materials wholly supplied by the tailor or sculptor.

482. Hire of service: custody, in general. The hire of custodial services embraces a wide variety of bailees, such as *agistors* (animal keepers, dog and cat hospitals, and so on), *livery stable* and *garage keepers*, *airplane hangars*, *warehousemen*, *wharfingers* (persons who keep wharves for the storage of goods), and *hotel, boarding and lodginghouse keepers*. The law governing keepers of motor vehicles, watercraft and aircraft, although considerably revised by statute, derives largely from the common law governing livery stables. The most common type of bailees furnishing custody are warehousemen and innkeepers.

483. Warehousemen: in general. A warehouseman is a bailee engaged in the business of storing goods for profit. Like all bailees, a warehouseman must redeliver the identical merchandise stored, except that the proprietor of a grain elevator, being engaged in the storage of *fungible* goods (sec. 410, subd. e), is required merely to return grain of equivalent quantity and quality.

484. Warehouse receipts. Warehouse receipts may be issued by any warehouseman. The importance of this type of docu-

ment of title and the need for a uniform application of legal rules in connection with its wide commercial use have led to the general adoption of a Uniform Warehouse Receipts Act (see pages 12-13). The act provides that warehouse receipts need not be in any particular form, but every such receipt must embody certain specific items in its written or printed terms.

Negotiable and nonnegotiable receipts. The Uniform Act defines a negotiable receipt as one in which it is stated that the goods received will be delivered to the bearer, or to the order of any person named in the receipt. A nonnegotiable receipt is one in which it is stated that the goods received will be delivered to the depositor, or to any other specified person. A nonnegotiable receipt must be plainly marked, "Nonnegotiable," or "Not Negotiable"; otherwise a holder for value who believes the receipt to be negotiable may, at his option, treat the receipt as imposing upon the warehouseman the same liabilities he would have incurred had the receipt been negotiable.

485. Liabilities of warehousemen. Unlike innkeepers and carriers of goods, warehousemen are not insurers (sec. 465), that is, they are not liable unless negligent. Hence a warehouseman is not liable for goods stolen from his warehouse without his negligence. The law does, however, impose upon warehousemen certain liabilities arising out of the nature of the bailment:

(a) A warehouseman must not and may not be compelled to deliver up the goods stored except against the warehouse receipts previously issued for them.

(b) If a receipt is lost or destroyed, a court, upon proper proof of the facts and the filing of a bond to secure the warehouseman, may order the goods delivered without a receipt; but if such receipt, negotiable in form, turns up in the hands of an innocent holder for value, the warehouseman may be liable to such person notwithstanding, in which event he is protected by the bond.

(c) Negotiable receipts must be cancelled when the goods are delivered; else the warehouseman is liable to any subsequent innocent holder of the receipt for value.

(d) A warehouseman who issues a fictitious receipt is guilty of a crime punishable by fine and imprisonment.

(e) If the proprietor of a grain elevator fails to keep on hand at all times an equivalent quantity of grain to answer the demands of depositors, he is guilty of conversion (sec. 29).

486. Warehouseman's lien. A warehouseman has a lien for storage charges against all goods brought into the warehouse by the owner or his agent. If a thief or other unauthorized

person deposits goods in a warehouse, the owner is not liable for storage nor subject to a warehouseman's lien. But if possession was entrusted to a person who, under the law, would have implied authority to pledge the goods (sec. 405), such person, so far as concerns a warehouseman's lien, would be deemed to have implied authority to store the goods.

487. Innkeepers: in general. Under the common law, an "inn" was a place which furnished travellers not only with lodging, but with food, drink and a stable for the care of their horses. Unless all these services were supplied, the place was not, legally speaking, an inn, and the rules of law governing innkeepers, including the benefit of an innkeeper's lien on the traveller's belongings, were inapplicable. Thus, though innkeepers have been entitled to a lien on a guest's belongings from the earliest days of the common law, no such right existed in favor of boarding and lodginghouse keepers until supplied by statute. Today, however, with the change in customs and modes of travel, it is not necessary for a hotel or similar establishment to supply food, drink and stable or garage accommodations in order to qualify under the law as an inn, so long as it receives transient guests (as distinguished from nontraveling or resident guests), and furnishes them with lodging.

Innkeeper's lien unique. An innkeeper's lien, which extends to a guest's entire belongings on the premises, is unique in that it is superior to all other claims. An innkeeper may therefore hold a guest's baggage as security for an unpaid bill even though such baggage does not belong to the guest or is covered by conditional sale or chattel mortgage. However, this rule does not apply if the hotel proprietor knew that the baggage did not belong to the guest.

488. Special duties and liabilities of innkeeper. An innkeeper's liability is unique because he comes into direct contact with the public and guests would be at his mercy if he were not charged with special responsibility. Among the more important duties and liabilities of an innkeeper are: (a) duty to serve all, (b) liability for safety of guests, (c) liability as insurer of guests' property.

489. Innkeeper's duty to serve all. An innkeeper must, without discrimination, serve all proper persons who apply for accommodation, and for failure to do so he is liable in damages to the person rejected.

490. Liability for safety of guests. An innkeeper's liability for the safety of his guests is that of using ordinary care; and

if a guest is injured while on the premises, but without the innkeeper's negligence, the innkeeper is not liable.

491. Liability as insurer of guests' property. As to a guest's *property*, an innkeeper is an *insurer*; that is, if such property is lost or stolen while on the premises, the innkeeper is liable whether he was negligent or not. However, an innkeeper's liability as an insurer of his guests' property is subject to the following exceptions: (a) *acts of God* (floods, hurricanes, earthquakes, fire caused by lightning, and so on); (b) *acts of the public enemy*; (c) *loss due to guest's own fault* (as where a guest fails to lock the door of his room); (d) *statutory limitations*.

492. Statutory limitations on innkeeper's liability. As a rule, hotels may limit their liability for guests' valuables by complying with certain statutory requirements. Thus, if a hotel provides a safe where guests may deposit their valuables, and posts proper notices to this effect, the hotel proprietor (unless he is guilty of negligence) is not responsible if a guest fails to heed the notice and his valuables are lost or stolen. Statutes also commonly protect a hotel proprietor against liability for valuables in excess of a given maximum (\$500 in New York and New Jersey, \$250 in Illinois), so that if such articles are deposited in the safe and lost, the hotel proprietor is not liable above the statutory maximum.

F. Carriers: Classification

493. Carriers defined and classified. A *carrier* is a bailee for hire engaged in the business of transportation. Carriers are commonly classified as (a) *private carriers*, (b) *common carriers*, (c) *carriers of goods*, (d) *carriers of passengers*, and (e) *ocean carriers*.

494. Private v. common carriers. A private carrier is one who undertakes to supply transportation in special instances and upon special arrangement, who does not hold himself out as ready to serve all who apply, and whose business is not of such general public concern as to be affected with a public interest. Examples are: private delivery services, truckmen and moving vans.

A common carrier is one who undertakes for hire to transport persons and goods for anyone who may choose to employ him.

Two liabilities which distinguish common carriers from private carriers are:

(a) *Liability for refusal to serve all who apply.* A private carrier may select whom he chooses to do business with. A common carrier is bound to serve all who apply, and for a refusal, without just cause, to serve any and all who apply, he is liable in damages.

(b) *Liability for loss or injury.* A private carrier is liable only as an ordinary bailee for hire, that is, only if he is guilty of negligence. A common carrier, in the transportation of goods, is charged with the risk of an insurer, that is, he is liable regardless of negligence.

The question of whether one is to be classed as a common carrier does not depend upon the carrier's desires in the matter, but upon the nature of the services he purports to render. If a person undertakes to engage in a business which is "affected with a public interest"—which touches the public on a wide scale—he must be prepared to serve all who apply, without discrimination. He must be prepared to subject himself and his business to public regulation in the public interest. Such a person, engaged in transportation, is known as a common carrier.

Interstate v. intrastate carriers. The distinction between *interstate* and *intrastate* carriers corresponds to the distinction between interstate and intrastate commerce (secs. 59 and 1544). An interstate shipment retains its character as such until delivery is made to the consignee or his agent.

Example: If a carload of explosives manufactured at Rock Island, Illinois, is shipped by rail for delivery in New York City, such shipment is interstate up to the point where the contents of the car are loaded on trucks and delivered to the warehouse of the consignee.

495. Carriers of goods v. carriers of passengers. The distinction between carriers of goods and carriers of passengers is not merely a distinction between transporting things and transporting persons, but in the legal duties and responsibilities arising out of such distinction, notably in the liability for loss, damage and injury (sec. 501).

496. Ocean carriers. Because of the nature of water transportation, ocean carriers are subject to certain rules and regulations peculiar to that type of service. These are briefly set forth under a separate classification (secs. 522 to 534).

497. Types of common carriers. Common carriers include many forms of quasi-public service in the field of transportation; among them, railway, express, steamship, public ferry, stage coach, omnibus and public trucking concerns.

G. Common Carriers of Goods

498. When carrier's liability begins. The liability of a carrier commences when the goods are delivered to it or to its authorized agent at the proper place for the purpose of transportation. If the shipper requests the carrier to hold the goods for further directions, the carrier's liability during that interval will be that of an ordinary bailee; so that if loss occurs during such period, without negligence of the carrier, there will be no liability.

499. When freight charges are payable. A common carrier may require freight charges to be paid in advance; and if not so paid, the carrier may refuse to receive the goods.

500. Duty to serve all. A common carrier of goods must serve all who apply, on payment or tender of the proper charges; and such charges must be uniform. For a failure to discharge such duty, a common carrier may be liable in damages. However, the duty to serve all indiscriminately does not apply to the following goods:

(a) Goods not of the character that the carrier transports (a taxicab driver cannot be forced to carry a horse, cow or piano, nor a railroad company to transport steel rails on a milk train).

(b) Goods not tendered at the proper time and place.

(c) Goods not properly packed.

(d) Dangerous goods.

(e) Goods injurious to public health.

(f) Perishable goods where the carrier has no immediate means of transportation.

501. Carrier's liability as insurer. Common carriers are insurers of goods in transit; that is, they are liable for loss, damage or destruction of merchandise entrusted to them for transportation, regardless of negligence. Common carriers are not, however, insurers of passengers; that is, they are not liable for injury to passengers unless it is occasioned by the carrier's negligence.¹⁸ The reason is obvious. Common carriers have complete control of the subject matter which they transport. If their liability for loss were to depend on negligence, it might be difficult to establish such liability, since the person suffering

¹⁸ *Missouri Pac. R. Co. v. Baum*, 196 Ark. 237, 117 S.W. 2d 31; *White v. Chappell*, 219 N.C. 652, 14 S.E. 2d 843; *Lentz v. Carolina Scenic Coach Lines*, 208 S.C. 278, 38 S.E. 2d 11; *Sine v. Salt Lake Transp. Co.*, 106 Utah 289, 147 P. 2d 875; *Cleveland v. Danville Traction & Power Co.*, 179 Va. 256, 18 S.E. 2d 913.

the damage or loss is in no position to establish its cause: he is not there when the loss occurs. A passenger, of course, is on the site when the injury occurs. He must prove negligence, though the burden of such proof is slight.

Example: The Black Paint Company receives an order to ship a barrel of paint via N.Y. Central R.R. Co. When the barrel reaches its destination, it is empty. If the Black Paint Company can prove that the barrel was full when shipped, the consignee (to whom title passed on delivery to the carrier) can hold the carrier for the loss without proving how it happened.¹⁹

When carrier is excused from liability as insurer. A common carrier of goods is excused from liability as insurer if loss, damage or destruction is due to one of the following causes:

(1) *Acts of God*, such as floods, snowstorms, hurricanes, cyclones, lightning or fires caused by lightning, and any other extraordinary natural causes beyond the carrier's control.

(2) *Acts of a public enemy*, during a period of organized warfare.

(3) *Fault of the shipper*, such as improper packing, misdirection of merchandise, failure to indicate delicate or fragile contents, and so on.

(4) *Acts of public authorities*, as in the case of seizure by law enforcement or health officers, or of due process, as by attachment, stoppage in transit, and so on.

(5) *Inherent nature of goods*, including perishables, livestock, and merchandise subject to natural deterioration.

502. When carrier may limit liability. In many states, carriers are prohibited by constitutional or statutory provision from limiting their liability for loss of goods through negligence. This is because it is contrary to public policy to bargain away the duty to be careful. These state provisions affect *intrastate* shipments only. *Interstate* shipments are governed by Federal statute. Under the Carmack Amendment to the Hepburn Act as subsequently further amended,²⁰ although a carrier cannot *exempt* itself from liability for negligence,²¹ it may, by agreement upon a maximum valuation, *limit* its liability for negligence, provided:

(a) The shipper receives consideration for the limitation (usually a lower rate).

(b) The shipper is given an option to ship without such limitation, though at a higher rate.

¹⁹ *Krulder v. Ellison*, 47 N.Y. 36.

²⁰ By the Cummins Acts.

²¹ It may, for a consideration, exempt itself from liability as an insurer. For a case dealing with this subject, see *S. S. Ansaldo San Giorgio I v. Rheinstrom Bros. Co.*, 294 U.S. 494.

(c) The limitation is reasonable and just; that is, it bears a fair relation to the reduced rate.

Examples:

(1) An express company may contract to place a maximum valuation and liability of \$50 for any parcel received for interstate shipment, regardless of whether the loss is negligent or not.

(2) If A ships goods worth \$500 upon an agreement limiting the railroad company's liability for loss to an amount not exceeding \$250, A is bound by his bargain in cases of loss.

(Both the above examples are subject to the three conditions just stated.)

503. Bill of lading: nature and contents. A bill of lading is an instrument in writing signed by the carrier or his agent, describing the freight so as to identify it, stating the name of the consignor and the terms of the contract for transportation, and agreeing or directing that the freight be delivered to a specified person or his order at a specified place.

Every bill of lading must embody within its written or printed terms at least the following: (a) date of issue, (b) name of person from whom goods have been received, (c) place where goods have been received, (d) place to which goods are to be transported, (e) statement whether goods received will be delivered to a specified person or to the order of a specified person, (f) description of goods or of packages containing them, and (g) signature of carrier.

A negotiable bill of lading must have the words "order of" printed immediately before the name of the person upon whose order the goods are deliverable.

Law governing bills of lading. The rules of the common law governing bills of lading have been largely superseded by statute, including the Uniform Bills of Lading Act applicable to intrastate shipments (see table on pages 12-13) and the Federal Bills of Lading Act (Pomerene Act) applicable to interstate and foreign commerce.

504. Bill of lading: fourfold functions. A bill of lading serves four distinct functions: (1) as a receipt, (2) as a contract, (3) as evidence of the kind, quantity and quality of the goods shipped, and (4) as evidence of title.

505. Bill of lading as receipt. When possession of goods is transferred from one person to another, the latter cannot be held responsible unless the fact of transfer and delivery to him can be established. The clearest proof of such transfer and delivery is a signed receipt. A bill of lading serves as a signed receipt and fixes liability on the carrier for custody and transportation.

506. Bill of lading as contract. Any instrument issued by a carrier upon receiving goods for shipment, to the extent that it contains stipulations about transportation, constitutes a contract governing the shipment. Its terms, therefore, bind both parties and determine their rights and liabilities. Thus the holder, under a bill of lading, may require the carrier to complete its terms on shipment and delivery, and the carrier may hold the shipper to the provisions and limitations of the bill, such as, for example, a limitation in liability (sec. 502).

Formal acceptance or knowledge of contents by shipper unnecessary. Neither formal acceptance nor knowledge by the shipper of the contents of the bill of lading is necessary to bind the shipper to its terms and provisions. “. . . as a general rule, in the absence of controlling statutes providing otherwise, if a formal bill of lading is executed by the carrier, delivered to the shipper and accepted by him as evidence of the terms of shipment, valid stipulations embodied therein limiting the carrier's liability will be binding on the parties, and no formal assent to the limitation of liability by signature to the bill of lading, or otherwise, is essential on the part of the shipper. . . .”²²

Example: A ships goods on a bill of lading which contains references to a classification under which the goods are sent. The goods are destroyed while in transit. The carrier offers to pay only a small part of the value of the goods by reason of a limitation in liability in the bill of lading. The shipper, claiming that he had no knowledge of the limitation in liability and that his attention had not been called to it by the shipper, insists on full payment. The carrier's position in such a situation will be sustained.

507. Bill of lading as evidence of kind and quantity of goods. A bill of lading is *prima facie* evidence (sec. 78) of the receipt by the carrier of the kind and quantity of goods therein described. It is customary to insert in a bill of lading recitals to the effect that the goods were received in good or apparently good condition. This is not conclusive, but unless the contrary can be shown, the presumption will stand. If the goods are intended to be negotiated, and they reach the hands of a *bona fide* transferee for value, the recital of good condition, as to him, may become binding on the carrier.

508. Bill of lading as evidence of title. A bill of lading is known as a *document of title* (sec. 282). By this is meant that the bill serves as documentary evidence of title and provides proof of ownership of the merchandise therein described. It is in effect a symbol of the title to the goods themselves, particularly in the case of an order bill; so that a transfer of the bill

²² 13 *Corpus Juris Secundum* 176.

of lading constitutes a transfer of title to the goods therein described.

509. Negotiable (order) bills *v.* nonnegotiable (straight) bills. The Uniform Bills of Lading Act defines a negotiable or order bill as one "in which it is stated that the goods are consigned or destined to the order of any person named in such bill." It defines a nonnegotiable or straight bill as one "in which it is stated that the goods are consigned or destined to a specified person." Strictly speaking, no bill of lading or other document of title is "negotiable" in the sense used in connection with negotiable instruments, since documents of title do not involve orders or promises to pay sums certain in money. However, the essence of negotiability, as noted in section 260, is that an instrument shall pass readily from hand to hand, free from restrictions that characterize ordinary assignments (sec. 261). In this respect negotiable bills of lading present four points of distinction from ordinary bills:

(1) *As to defect in transferor's title:* The transferee of a nonnegotiable bill acquires only such title as the transferor has. A bona fide transferee of a negotiable bill of lading (that is, one to whom a bill is negotiated for value, without notice) acquires good title though the transferor's title was defective, as where the original owner was deprived of possession of the document by loss, theft, fraud, accident, mistake, duress or conversion.²³

(2) *As to judicial process:* Once goods are shipped against a negotiable bill of lading, such goods cannot be attached or levied upon in legal proceedings against the shipper, and while the goods are in the possession of a carrier or other bailee, unless the bill of lading is first surrendered or its negotiation enjoined. This is not true of a nonnegotiable bill.²⁴

(3) *As to stoppage in transit:* When a negotiable bill has been issued, the unpaid seller cannot, by stoppage in transit (sec. 423), defeat the rights of a purchaser for value in good faith to whom such bill has been negotiated, nor is the carrier obliged to deliver the goods or justified in delivering them unless such bill is first surrendered for cancellation.²⁵ This is not true of a nonnegotiable bill.

(4) *As to liens:* Liens or claims of a seller, shipper or prior transferor are invalid against a purchaser in good faith and for value to whom a negotiable bill of lading has been negotiated. The purchaser enjoys no such immunity when the bill of lading is nonnegotiable.

510. Authority to issue bill of lading. The Uniform Bills of Lading Act makes it a criminal offense punishable by imprison-

²³ Uniform Sales Act, sec. 38.

²⁴ Uniform Sales Act, sec. 39.

²⁵ Uniform Sales Act, sec. 42.

ment not exceeding five years, or by fine not exceeding \$5000, or by both, for any officer, agent or employee of a carrier to issue a bill of lading, knowing that all or any part of the goods for which the bill is issued has not been received by such carrier. Since no one is authorized to issue a bill of lading except against actual receipt of the goods, the common law rule, still in force in some states, is that a carrier is not liable on an unauthorized bill, even to one who in good faith has given value in reliance upon the description contained in the bill. This rule, however, has been modified by statute. The Federal Uniform Bills of Lading Act, applicable to interstate shipments, and the Uniform Bills of Lading Act, applicable to intrastate shipments in the states which have adopted the act (see pages 12-13), provide in effect that when a bill of lading is issued by an agent or employee acting within the scope of his actual or apparent authority, the carrier is liable thereon to "one who has given value in good faith relying upon the description therein of the goods," notwithstanding the nonreceipt of the goods therein described.

Example: Hart, captain of a ship, contrary to orders, signs a bill of lading for goods not received. If the shipment is interstate or to a foreign country, or intrastate in a jurisdiction which has adopted the Uniform Bills of Lading Act, the carrier is liable to an innocent third person who in good faith dealt with Hart in reliance upon the bill of lading. The carrier would not be liable to such third person in jurisdictions where the common law rule obtains.

511. Express receipts. Uniform express receipts are prescribed by the Interstate Commerce Commission. For intrastate shipments, they may be approved by state regulatory bodies, such as public service and public utility commissions. The Court has held²⁶ that a provision in an express receipt exempting the express company from liability for loss, damage or delay caused by acts of God, public enemies, riots, strikes, and so on (unless caused by the carrier's own negligence), is not inconsistent with public policy or Federal transportation laws; and that a shipper is presumed to have known and assented to such conditions contained in a uniform express receipt issued and accepted in connection with the shipment."

512. Rules governing delivery. A common carrier of goods must make delivery at the proper time, to the proper person, and at the proper place.

²⁶ *Feniger v. American Railway Express Co.*, 226 Mich. 106.

(a) *Time of delivery.* If a carrier undertakes to deliver within a specified time, it is liable for any loss due to delay, regardless of cause. If no time for delivery is specified, it must be made within a reasonable time.

(b) *Delivery to the right person.* A carrier is liable for mistake in delivery to the wrong person. Fraud practiced on the carrier is no excuse, because a carrier of goods is an insurer.

(c) *Place of delivery.* The place of delivery may be governed by the bill of lading, or by custom. It has been the custom for express companies to deliver to the consignee's door and for railroad companies to deliver to their freight offices; but competition with motor transport has induced railroad companies in many instances to inaugurate personal delivery service.

(d) *C.O.D. shipments.* When a carrier agrees to collect on delivery, it is liable for loss resulting to the shipper from a failure to collect on delivery.²⁷

513. Initial *v.* connecting carriers. When a shipment of goods must necessarily pass over the lines of more than one carrier, the carrier to which goods are delivered in the first instance is known as the *initial carrier*. When the initial carrier passes the goods along to the next carrier beyond its lines, such carrier and all subsequent similar carriers are known as *connecting carriers*. The rules of liability governing initial and connecting carriers, though uniform as to *interstate* shipments, are not uniform as to *intrastate* shipments.

514. Liability of initial and connecting carriers. The rules governing the liability of initial and connecting carriers may depend upon whether the shipment is interstate or intrastate.

Interstate shipments. Under the Carmack amendment to the Interstate Commerce Act, as amended, connecting carriers are treated as agents of the initial carrier, and the latter is liable for any loss or damage occurring during the shipment, whether on its own line or on that of the connecting carrier. If the initial carrier is required to pay such loss, it may recover such payment from the connecting carrier. A stipulation in a bill of lading that the initial carrier will not be liable for loss occurring on the lines of a connecting carrier is specifically forbidden by statute. Under the *Motor Carrier's Act of 1935*, the Federal rule making initial carriers liable in the first instance applies to shipments by truck as well as to shipments by rail.

Intrastate shipments. Under the common law, when an initial carrier delivered the goods in good condition to the connecting carrier, his liability ceased and the shipper or his consignee had to look to the connecting carrier for any loss or damage occurring thereafter, unless the initial carrier accepted the goods for *through transportation*, in which case the courts held that the carrier assumed complete liability for the shipment throughout. As to *intrastate* shipments, this is still the rule in some states. In other

²⁷ *Okin v. Railway Express Agency* (N.J.), 44 A. 2d 896.

states, the rule has been modified by statute. In New York, for example, the statute provides²⁸ that "Any one of two or more corporations owning or operating connecting roads within this state, or partly within and partly without the state, shall be liable as a common carrier, for the transportation of passengers or delivery of freight received by it to be transported by it to any place on the line of a connecting road; and if it shall become liable to pay any sum by reason of neglect or misconduct of any other corporation it may collect the same of the corporation by reason of whose neglect or misconduct it became liable."

515. When carrier's liability ends. The liability of a carrier ends when the goods have been delivered to the consignee, or, where actual delivery is not required, as in the case of railroad companies and carriers by water, when the carrier's duty *as carrier* has been discharged. Thereafter, if the goods remain in the carrier's possession, such custody is no longer that of an insurer liable regardless of negligence, but of an ordinary bailee liable only for negligence.

When carrier's duty is discharged. The courts of the country are not in agreement on when a carrier's duty is discharged following completion of transit. There are three distinct views on the subject, known, respectively, as the Massachusetts Rule, the New Hampshire Rule and the New York Rule.

(1) *Massachusetts Rule:* When transit is completed, and the carrier has placed the goods in his warehouse awaiting delivery to the consignee, the carrier's duty as such is ended, though no notice is given to the consignee. Thereafter, the carrier is liable as warehouseman only.²⁹

Example: Goods shipped by rail, while in the railroad's warehouse awaiting delivery to the consignee, are destroyed by fire, without negligence on the part of the railroad. The loss falls on the consignee, though no notice of arrival was sent.

(2) *New Hampshire Rule:* Merely placing goods in the railroad warehouse does not discharge the railroad, which remains liable as an insurer until the consignee has had a reasonable time after their arrival to inspect the goods and take them away in the common course of business.³⁰

Example: In the previous example, liability under the New Hampshire Rule would fall on the railroad unless the consignee had a reasonable time after their arrival to inspect the goods and take them away in the common course of business.

(3) *New York Rule:* Liability of the carrier as insurer continues until the consignee has been notified of the receipt of the goods and has had a

²⁸ *Railroad Law*, section 70.

²⁹ This rule is supported by decisions in the following states: Illinois, Indiana, Iowa, Massachusetts, Missouri, New Jersey, Ohio and Tennessee.

³⁰ This rule is supported by decisions in the following states: Arkansas, Connecticut, Kansas, Kentucky, Minnesota, New Hampshire, Pennsylvania, South Carolina, Vermont, Washington, West Virginia and Wisconsin.

reasonable opportunity thereafter to take the goods away. (Differs from the New Hampshire Rule only in the necessity of notice.)³¹

Example: In the previous example, liability under the New York Rule would fall on the railroad unless the consignee had received notice of arrival and had had a reasonable opportunity thereafter to take the goods away.

H. Common Carriers of Passengers

516. Definition. A common carrier of passengers is one engaged in transporting for hire any and all *persons* who apply.

Examples: Steam and electric railways, omnibuses, steamship lines, taxicabs and air transport lines.

517. Duration of carrier's liability. The liability of a common carrier of passengers begins when one enters the carrier's premises (waiting room) for the purpose of becoming a passenger, and ends when the trip is completed and the passenger has left the carrier's premises.

518. Right to prescribe time, place and manner of paying fares. "In the absence of a statute to the contrary, a carrier may make and enforce reasonable regulations as to the time, place, and mode of payment of fare. As a general rule, the time of taking the fare, whether at the carrier's station or office, or in the car or other vehicle, is immaterial, but the carrier may demand prepayment of fare, and, if it does not, it must be presumed to rely on its lien on the passenger's baggage or on his integrity."³² The carrier may insist on cash, but the passenger need not tender the exact fare, though the carrier may prescribe reasonable rules as to the maximum amount for which it will make change.

519. Liability of common carrier of passengers. A common carrier of passengers must exercise the highest degree of care for the lives and safety of its passengers. To ensure that this liability is properly discharged, regulatory bodies, state and Federal, prescribe rules, conditions, safety devices and appliances, and maintain periodic inspections. For any loss of life or injury to a passenger due to a carrier's negligence, the carrier must respond in damages. However, a carrier of passengers is not an insurer; that is, there is no liability unless *some negligence* can be shown.

³¹ This rule is supported by decisions in the following states: Alabama, California, Maryland, Michigan, New York, North Carolina and Oregon.

³² 13 *Corpus Juris Secundum* 1148.

520. Accommodations. A carrier of passengers must provide accommodations usual in the type of service offered. Under ordinary conditions, every passenger is entitled to a seat, and if he is unable to obtain one, he may quit the train at the next stop without paying his fare; but he cannot both ride and refuse to pay. Under extraordinary conditions such as war, emergencies, or insurmountable traffic conditions, the right to accommodations is subject to such conditions. The courts have held that if a passenger pays his fare, and a seat is not available, he may not only have his fare back and quit the train, but he may hold the carrier liable for breach of contract.³³

521. Baggage. A passenger ticket includes the fare for transporting a passenger's baggage as well as himself. "Baggage" includes the passenger's personal belongings necessary for his business and personal requirements.

Examples:

(1) "The sportsman who sets out on an excursion for amusement in his department of pleasure, needs, in addition to his clothing, his gun and fishing apparatus; the musician, his favorite instrument; the man of letters, his books; the mechanic, his tools. In all these cases, and in a vast number of others, unnecessary to enumerate, the articles carried are necessary, in one sense, to the use of the passenger. He cannot attain the object he is in pursuit of, without them, and the object of his journey would be lost, unless he was permitted to carry them with him. Yet, under pretense of carrying these articles, it by no means follows, that the carrier is bound to carry a box of guns, a pianoforte, or organ, a library, or the tools and machinery of a machine shop."³⁴

(2) See section 1555.

When baggage is "checked" (delivered into the custody of the carrier), the carrier is liable for it just as if it were a carrier of goods; in other words, its liability is that of an insurer. The right of a carrier of goods to exempt itself from its liability as an insurer, or to limit its liability for negligence (sec. 502) applies also to a carrier of passengers in respect to baggage. However, in the absence of negligence, a carrier is not

³³ *Davis v. N.Y. Central R. Co.*, 163 Misc. 710, 298 N.Y. Supp. 44; *same v. same*, New York Law Journal, November 18, 1938; *Lafayette, etc. R. Co. v. Sims*, 27 Ind. 59; *Chesapeake, etc., R. Co. v. Austin*, 137 Ky. 611, 126 S.W. 144, 136 Am. S.R. 307.

³⁴ *Merrill v. Grinnell*, 30 N.Y. 594. See, also, *Lang v. Illinois Greyhound Lines*, 306 Ill. App. 269, 28 N.E. 2d 345; *Ward v. Gulf, M. & N. R. Co.*, 23 Tenn. App. 533, 134 S.W. 2d 917.

liable for a passenger's hand baggage, because the passenger, not the carrier, has possession of such baggage.

I. Carriers by Water

522. Status of shipowner as common carrier. The owner of a ship carrying goods for hire in the usual course of business and for all who may apply, whether by ocean or inland waters, whether in foreign, interstate or intrastate commerce, and whether his vessel is a sail boat, steamboat, canal boat or any other kind of a vessel, is a common carrier and is subject to a common carrier's liability. However, by reason of the nature of water transport, certain rules of law are peculiar to carriers by water.

523. Duty to receive and transport property. Although the obligation of a common carrier to accept all goods tendered for shipment extends to a vessel just as to any other carrier, a steamboat leaving its terminal with a full cargo is not required to overload by taking additional freight. Moreover, a carrier by water may select the character of the goods it proposes to carry, or may discontinue the transportation of a particular class of goods.

524. When liability of shipowner begins. Accepted delivery to the ship's side is sufficient to put the cargo at the vessel's risk, though the shipper reserves the right to reject and unload undesirable goods after loading.

525. Lien of shipper. A shipper has an unusual remedy against a carrier by water, in that he has a lien *on the vessel* for the fulfillment of the contract of transportation. This lien attaches to the ship from the time the goods are delivered and the cargo, or some portion of it, is loaded on board or delivered to the master. There is no lien, however, for breach of contract in failing to call for the cargo. The shipper's lien is not a substitute for, but an additional remedy to that of breach of contract.

526. Marine bills of lading. Marine bills of lading fulfill substantially the same functions as those for the transportation of goods generally. A *clean bill of lading* is one which contains nothing in the margin qualifying the words in the bill of lading itself. The term is also applied to a bill of lading that is silent as to the mode of stowing the goods and that contains no exceptions to the liability of the master except the

usual one that all liability assumed by the carrier is subject to the risks and dangers of the sea. A shipper of goods by vessel is entitled as a matter of law to a bill of lading, and the master is bound to give one when the goods are stowed on board, even if the freight is not agreed upon.

527. Liability for injuries. The owner of a vessel is liable for injuries sustained by any person on or about the vessel who is rightfully on board, provided such injury was the result of some negligence of the master.

528. Bottomry and respondentia. Marine transportation is frequently financed by advances secured through bottomry or respondentia bonds.

A *bottomry bond* is an instrument embodying a contract or agreement of bottomry, that is, a contract for the loan of money on the "bottom" or hull of a ship, at an extraordinary interest, upon maritime risks, to be borne by the lender for a voyage, or for a definite period.

Respondentia is a contract by which a cargo, or some part of it, is hypothecated as security for a loan, the repayment of which is dependent upon maritime risks. The instrument embodying the contract or agreement is the *respondentia bond*.

529. Consular invoice. Because of the uncertainties and vicissitudes of foreign commerce, consular invoices are frequently resorted to in the transportation of goods by water. A consular invoice is one the correctness of which is sworn to before a consul.

530. Demurrage. Originally, *demurrage* was the term used to designate the sum allowed to the owner of a ship for the detention of his vessel beyond the number of days allowed for loading or unloading, or for sailing. However, the term has been broadened to include railroad company charges for the storage of goods under similar conditions.

531. Nationality of vessels. The ownership of a vessel determines its nationality. If the owner is an American citizen, or an American corporation, the vessel is American.

532. Registry, enrollment and licenses. Acts of Congress provide a system of registry and enrollment. Vessels are required to be registered and enrolled in the collection district embracing the port nearest to which the owner resides. Such registry gives the owner of the registered vessel the license to operate it, and the protection of the laws of the United States.

Only citizens of the United States are entitled to have their vessels registered.

533. Inspection, equipment and personnel. Acts of Congress provide a comprehensive scheme for the inspection of vessels, including periodic inspection of boilers, hulls, safety equipment, and so on.

534. Charter parties. A charter party is a contract by which the owners let an entire vessel or some principal part of it to another person, to be used by the latter in transportation for his own account, either under his own charge, or under the charge of the owners. The contract is also referred to as a *contract of affreightment*.

J. Regulation of Carriers

535. Basis of regulation. Carriers, particularly common carriers, by reason of the extent to which they are affected by a public interest and constitute *public utilities*, are subject to control by the government in the valid exercises of its police power (sec. 67).

536. Purpose of regulation. It is the purpose of government regulation of carriers to insure a proper discharge of their functions, not only through the usual remedies available by court action, but under the supervision and control of administrative bodies established with a view to maximum service at minimum cost compatible with a fair rate of return on the investment. To achieve these objectives, regulatory bodies maintain a system of physical inspection, prescribe standard account and record forms, and require periodic reports on forms prescribed for such purpose. (See section 1544.)

537. Regulation of interstate carriers: Interstate Commerce Commission. With certain exceptions, interstate carriers are subject to regulation and control by the Interstate Commerce Commission. The Interstate Commerce Act was passed to ensure just and reasonable charges for transportation, prohibit unjust discrimination, and to prevent undue or unreasonable preferences. The various provisions of the act are designed to accomplish these purposes. The jurisdiction of the Interstate Commerce Commission, originally extending to the transportation of passengers or property by rail or water, has since been extended to include express companies, pipe lines, sleeping car companies, telephone and telegraph companies

and the transportation of passengers and property by motor carriers engaged in interstate or foreign commerce. (See section 1556.)

Commerce by air is subject to regulation and control by the Civil Aeronautics Authority.

538. Regulation of intrastate carriers. Intrastate carriers are regulated by state utility or public service commissions. For example, intrastate carriers in New York report to the Public Service Commission, except those operating wholly or partly within the City of New York, which report to the Transit Commission.

Questions and Problems for Review

1. Define "bailment of goods." Name and define the terms used to distinguish the persons concerned in a bailment of goods. *NY June 1932 (2)*

2. What *three* elements must be present in order to give rise to a bailment? *NY Apr. 1933 (12)*

3. Distinguish between (a) a bailment and a sale, (b) a bailment and a consignment of goods to a commission merchant. *NY May 1926 (14)*

4. Wilson, the owner of a flour mill, contracted to take the wheat of Harvey and to give Harvey one barrel of superfine flour for every five bushels of wheat. Wilson, pursuant to this agreement, delivered to Harvey forty bushels of wheat. Before the delivery of the eight barrels of flour, the mill burned without any negligence on the part of Wilson. Harvey now sues Wilson for the value of the eight barrels of flour. Will he succeed? Explain. *NY Nov. 1926 (9)*

5. Distinguish between (a) bailment and sale, (b) bailment and gift. *NY Nov. 1929 (5)*

6. Black delivered to Green certain cotton goods which were to be manufactured by Green into ladies' dresses to be sold by Black. The establishment of Green was burglarized and these goods were stolen.

It had been agreed as between the parties that Black was to charge Green on his books of account for the goods at a specified price per yard, and that the price of the goods was to be offset against the contract price of the garments.

Suit being brought by Black against Green, the issue hinged on whether the transaction was a sale or something else.

What decision, and why? *NY Apr. 1934 (12)*

7. Beaman and Cole were joint owners of a vessel. The boat sailed on a voyage to Europe. On the day of sailing, the two owners had a conversation about insuring the vessel. Beaman said he

would insure it at once. However, he did nothing toward effecting any insurance. The boat sailed and was lost in a storm. Cole brought suit against Beaman, seeking to hold him for damages resulting from his failure to do as he promised.

Decision for whom, and why? *NY Apr. 1933 (14)*

8. As used in the law of bailments, what is (a) conversion, (b) mutuum? *NY Nov. 1928 (9)*

9. A banker accepts from his customer, for safekeeping, a package of money and securities marked with the depositor's name. The package is subsequently stolen by the banker's cashier, who had previously borne a good reputation. Is the banker responsible? If so, upon what principle? *NY Jan. 1918 (9)*

10. A hires an automobile from the Drive-Yur-Self Auto Co. at \$1.00 an hour. Through no fault of A the car is damaged in collision with B. Is A liable to the renting corporation? Is B liable to A or to the corporation? *AI Nov. 1927 (5)*

11. A borrowed \$75 from B, giving to B as security for the loan a valuable Swiss watch. B placed the watch in his office safe. Burglars entered B's office, broke open the safe and took its contents including the watch. Is B liable for the loss of the watch? *AI Nov. 1926 (8)*

12. Zindle a jeweler, gave Mrs. Chapman, a prospective customer, a diamond brooch of the retail value of \$5200 to wear while she was deciding whether or not to purchase it. Mrs. Chapman was accustomed to wearing expensive jewelry, and at all times when she wore this brooch she wore other expensive pieces of jewelry of her own. To all of the jewelry she gave what women of her social standing regard as reasonable care. Nevertheless, the brooch was lost or stolen. Must she pay for it? *AI May 1933 (11)*

13. Jones, on an automobile trip from New York to Boston, agreed to take a valuable parcel for his friend Smith and to deliver it to Smith's son in Providence. Jones stopped in Bridgeport for dinner. He took his own property out of the car at the hotel, but Smith's parcel, which was left in the car, was stolen while the car was parked. Discuss the principles involved. *AI Nov. 1929 (6)*

14. State fully the bailee's liability in each of the following: (a) loan for use, (b) hiring for a reward. *NY Nov. 1927 (8)*

15. In what three ways does a pledge differ from a chattel mortgage? How must the pledgee proceed when the pledgor is in default? *NY May 1931 (11)*

16. B, a depositor in the Cotton Exchange Bank, borrowed \$5000 from the bank, for which he gave his negotiable promissory note payable sixty days from its date. B, as sole collateral security for the payment of the said note pledged with the bank five \$1000 bonds, on an agreement that such bonds be sold if default should be made in the payment of the note, and that the net proceeds of such sale

should be applied to the payment of the debt. *B* failed to pay the note at maturity. The net proceeds of the sale of the bonds amounted to \$4000, and *B* was still indebted to the bank in the sum of \$1000 and interest. *B* had on deposit for safekeeping with the bank two Liberty Bonds for \$1000 each. Has the bank a legal right to sell these bonds and apply the proceeds to the payment of *B*'s indebtedness without *B*'s consent or a judgment of the Court? Give reasons. *NY Jan. 1926 (2)*

17. *X* stores goods with *Y*, a warehouseman. The goods are stolen from the warehouse without negligence on the part of *Y*. Is *Y* liable for the goods? If so, why? If not, why not? *NY June 1921 (10)*

18. (a) Define innkeeper.

(b) At common law, what right can an innkeeper exercise over goods in his possession brought by a guest?

(c) By what technical name is the innkeeper's right known?

(d) Can the innkeeper's right be exercised over goods brought in by the guest but actually belonging to some other person? *AI May 1932 (6)*

19. Define "common carrier." What two liabilities distinguish common carriers from other carriers? Why are they so liable? *NY Nov. 1930 (8)*

20. What is a common carrier? a bill of lading? Is a bill of lading negotiable? *AI Nov. 1925 (II-11)*

21. When are freight charges payable to a common carrier? *NY Jan. 1924 (15); NY Jan. 1920 (13); NY Jan. 1919 (2)*

22. What is a common carrier's liability for goods he carries, and what conditions free him from the liability? *AI Nov. 1926 (3)*

23. The Black Paint Company receives an order from Paul Field of Johnstown, N.Y., to ship a barrel of paint via N.Y. Central R. R. Co. When the barrel reached its destination it was empty. Can Paul Field recover from the railroad for the value of the paint lost? Explain. *NY Jan. 1921 (13)*

24. A ships goods on a bill of lading which contains certain reference to a classification under which the goods are sent. The goods are destroyed while in possession of the carrier. The latter offers to pay only a small part of the value of the goods, claiming that under the rates under which these goods are shipped, the carrier's liability is limited to the amount that they offer as compensation. The shipper claims he had no knowledge or notice of the limited liability at the time of the shipment. Can the shipper collect full value? Explain. *NY Jan. 1917 (15)*

25. Define a bill of lading and state what it represents and how it is regarded in commercial law. *NY Jan. 1925 (2); NY June 1921 (4)*

26. Hart was the captain of a ship owned by the Dailey Corporation. Contrary to his general orders, Hart signed a bill of lading for goods which had not been received.

(a) Can the Dailey Corporation be held liable to an innocent third person who in good faith dealt with Hart in reliance upon the bill of lading?

(b) Upon what principle of law is your answer based? *AI May 1932 (9)*

27. A carload of explosives, which were manufactured at Rock Island, Illinois, was sold to a resident of the State of New York and shipped to him by rail for delivery in New York City. Upon arrival there, the contents of the car were loaded on trucks and delivered at the warehouse of the consignee, who thereafter sold them at retail. At what point did these explosives cease to be articles of interstate commerce and become subject to the law of the State of New York? *NY June 1924 (4)*

28. Under the provisions of the Interstate Commerce Act is the initial carrier liable for damage or loss to a shipment due to negligence of the employees of a connecting carrier? Explain. *NY Nov. 1928 (7)*

29. Define (a) bill of lading, (b) charter party, (c) a consular invoice, (d) a bottomry bond, (e) a respondentia bond. *NY June 1918 (5)*

30. A railway company receives goods from a shipper, and the bill of lading contains the provision that the company will not be responsible for any loss occurring on lines beyond its own. The railway company proves that the loss occurred on one of the connecting lines over which it had no control. Can the shipper recover? Give reasons. *NY Jan. 1916 (11)*

31. Goods shipped to you by railroad, while in the railroad's warehouse awaiting delivery to you, are destroyed by a fire which is not due to any negligence on the part of the railroad. What are the important facts to be determined in order to establish upon whom the loss falls? *AI May 1929 (10)*

32. (a) What is the purpose of the Interstate Commerce Act?

(b) Name five practical provisions of this law. *NY May 1931 (12)*

CHAPTER VI

Agency

539. Scope of chapter. In this chapter we consider the nature of agency, the parties concerned therein, and the different kinds and classifications of agents. We then consider how an agency may be created and, upon its creation, what the rights, duties and obligations of principal and agent are in respect to each other, and in respect to third parties. We then examine the different ways in which an agency may be terminated; also some of the more important rules of law governing real estate brokers, stockbrokers, auctioneers and factors (commission merchants). Finally, we present a brief resume of the law governing employer and employee, including provisions for employers' liability and workmen's compensation, minimum wage, child labor, collective bargaining and social security.

A. Agency Relationship and Parties Concerned Therein

540. Agency defined. Agency is a relationship wherein one person, known as *agent*, acts for another, known as *principal*, in dealing with *third parties*.

541. Classifications and distinctions. Agencies may be variously classified and distinguished as follows: (a) as to scope of authority: *general* and *special*; (b) as to manner of appointment: *express* and *implied*; (c) as to reality of appointment: *actual* and *ostensible*; and (d) as to nature of employment. The law also distinguishes between an *agent* and a *servant*, an *agent* and an *independent contractor*, an *agent* and a *trustee*, and an *agent* and a *subagent*.

542. General v. special agents. A *general* agent has broad authority to represent his principal, as distinguished from a *special* agent whose authority is limited to a specific task or to a series of routine tasks. As more fully discussed in sections 567 and 568, a principal is bound by the acts of a *general* agent even though the latter exceeds his authority, provided such acts are usual and customary in that type of agency and the

third party is unaware that the agent has exceeded his authority; whereas a third party dealing with a *special* agent can hold the principal only to the extent of the special agent's *actual authority*.

Examples:

(1) Smith owns several stockyards. He puts Green in charge of one of them with instructions to hire only a certain number of men. Green hires more than this number of men. Smith is liable for the wages of the extra men. Green was a general agent. The extra men were unaware of Smith's instructions to Green.

(2) An agent was appointed solely to take orders for merchandise. He collected \$500 from a customer and disappeared. Since the customer was dealing with a special agent, the principal was not bound by the agent's unauthorized collection.

Universal agent. A universal agent is one whose authority not only embraces that of a general agent, but is even broader: he is empowered (usually by an unlimited power of attorney) to do all things for a principal that the principal might do for himself (except, of course, those things which a principal cannot physically or legally delegate to another). Universal agencies are rare. They are resorted to, as a rule, only where special circumstances make it desirable to vest complete authority in the agent. Such special circumstances might embrace physical disability on the part of the principal; or the fact that the principal is distant from the place of the transaction; or the fact that the principal will have to be absent for an extended period.

543. Express and implied agencies. When an agent's authority is created by a written contract, as by a *power of attorney* (sec. 550), or by an oral appointment, the agency is *express*. When the authority is inferred from the circumstances, the agency is *implied*.

544. Actual and ostensible agent. An agency, express or implied, is sometimes referred to as *actual* to distinguish it from an *ostensible* agency, or one created by law, regardless of the principal's wishes, to prevent injustice; as in the case of an agency by *estoppel* (sec. 553).

545. Agents classified as to nature of employment. Among the more common types of agents classified as to the nature of their employment are:

(a) *Salesmen*, engaged to sell real or personal property for their principals.

(b) *Brokers*, also engaged to negotiate the sale of real or personal property, but with functions usually broader than those of an ordinary salesman. Brokers are to be distinguished in a number of respects from ordinary agents (see sec. 583).

(c) *Proxies*, or persons appointed to vote for a principal at some meeting or conference; for example, a *stockholder's proxy*.

(d) *Delegates*, or persons designated by a body of persons to represent them in some assembly or convention.

(e) *Attorneys at law*, or persons specially qualified to represent other persons, known as clients, in matters of a legal nature.

(f) *Auctioneers*, or persons authorized or licensed by law to sell lands and goods for other persons at public auction.

(g) *Factors or commission merchants*. A factor or commission merchant is an agent who sells or disposes of merchandise consigned to him by the principal, usually in the agent's own name, for a commission called *factorage*. The relation of a commission agent to his principal is the same as that of any agent to his principal, with certain exceptions (sec. 1590). Factors may be either *domestic* or *foreign*, according as they reside and do business in the same or a different state or country with the principal.

(h) *Mercantile agents*. A mercantile agent is one employed to furnish information on the credit, character, financial standing, responsibility and reputation of merchants.

(i) *Del credere agents*. A *del credere* agent is one who for a higher commission guarantees the accounts of his customers. Although a special promise to answer for the debt of another must be in writing (secs. 185 and 916), this rule does not apply to a *del credere* agent (sec. 921).

546. Additional classifications and distinctions. Other classifications and distinctions in respect to agents are as follows:

(a) *Agent v. servant*. (See sec. 603.)

(b) *Agent v. independent contractor*. An agent is subject to the control and supervision of the one who employs him; but this is not true of an independent contractor. Hence, for the contracts and torts of an agent in the course of his employment, a principal, who has the right to control him, is liable; but for the contracts and torts of an independent contractor who has complete charge and supervision of the work that he does for another, the latter is not liable.¹

Examples:

(1) A certified public accountant, making a balance sheet audit of a coal dealer's business, engaged an engineer at his own expense to survey coal piles and report to the accountant the quantity in each pile. To do this, the engineer purchased certain supplies. Such purchases cannot be charged to the coal dealer. The engineer was an independent contractor.² (See sec. 1559.)

(2) If I hire you to build me a garage, and in the course of construction a third party is injured through your carelessness, I am either liable or not, depending, respectively, upon whether you are my agent, or an independent contractor.

¹ *Dean v. Ketter*, 328 Ill. App. 206, 65 N.E. 2d 572.

² Some authorities hold that a public accountant is himself an independent contractor. See section 560.

(c) *Agent v. trustee.* There are three differences between an agent and a trustee: (1) An agent has no title to the property he handles. A trustee has the legal (but not equitable) title to the property in his custody. (2) An agent acts in the principal's name. A trustee acts in his own name. (3) An agency may generally be revoked by the principal at any time (see sec. 578). A trustee, as a rule, retains his authority until the purpose of the trust is fulfilled, and can be removed only for cause.

(d) *Agent v. subagent.* An agent derives his authority directly from the principal; a subagent, from an agent expressly or impliedly authorized to appoint subagents.

(e) *Agent v. escrow holder.* An agent acts for a principal in dealing with third parties. He cannot act for both principal and third party, if their interests conflict. An escrow holder acts for two adverse parties in accepting and holding some instrument or thing of value, such as a deed, document of title, money or securities, deposited by one of the parties for delivery to the other upon the happening or fulfillment of a condition. An agent's authority may generally be revoked at any time by the principal. An escrow holder's authority is irrevocable, except upon the consent of all parties. (See secs. 1557, subd. (c) and 1814.) The parties to an escrow transaction are *grantor*, *grantee* and *escrow holder*, also known as *donor*, *donee* and *depository*.

(f) *Attorney at law v. attorney in fact.* An attorney at law is a person specially qualified to represent other persons, known as clients, in matters of a legal nature. An attorney in fact, in a strictly legal sense, means an agent acting under a special power created by some instrument or deed, such as a "power of attorney." In a loose sense, however, the term is frequently employed to mean all agents except attorneys at law. The act of designating an attorney in fact is sometimes referred to as *procuration*; such attorney in fact is sometimes referred to as an *agent by procuration*.

547. Who may be principal. The general rule as to the capacity of parties to appoint agents is reflected in the doctrine that whatever a person may do himself, he may do through another.³

(a) *Infants*, under the earlier rulings, were deemed incapable in law of appointing agents. Hence the general rule prevailed that an infant could not be a principal. This is no longer the rule in a majority of states. In most states the appointment of an agent by an infant principal is valid, but voidable, at the option of the infant, unless such appointment is a necessity and not a luxury to the infant. (See sec. 1560, subd. (a).) "Probably courts would still hold an infant unable to authorize a confession of judgment or to appoint an attorney for judicial proceedings; but there seems no reason except the antiquity of the rulings to that effect which can support the broad proposition that an infant's power of attorney or appointment of an agent is void; and generally, in recent cases, courts have been

³ *Jefferson Standard Life Ins. Co. v. Guilford County*, 226 N.C. 441, 38 S.E. 2d 519, 525; *Hodge v. Feiner*, Mo. App., 78 S.W. 2d 478, affd. 338 Mo. 268, 90 S.W. 2d 90, 103 A.L.R. 483.

disposed to treat the creation of an agency by an infant, like other agreements made by him, as merely voidable. A ratification by an infant of an act done on his behalf but without his authority, stands logically on the same ground as an act originally authorized by an infant principal, and has been held binding.”⁴

(b) *Corporations* are not only competent to act as principals, but, being fictitious persons, they cannot act except through human agency.

(c) *Married women* under the common law were incapable of entering into contracts on their own behalf. This rule has been generally superseded by statute, so that married women have the same contractual powers as all other adult persons. Hence a married woman has the same power to appoint an agent as her husband has.

(d) *Insane persons*, as we have noted in the chapter on contracts (sec. 139), are mentally incapable of contracting. Contracts made by insane persons after they have been adjudged insane by a court, are void; prior to such adjudication, voidable. This rule applies to all contracts, including contracts of agency.

(e) *Unincorporated clubs* and other voluntary associations, such as churches, political organizations, and so on, are not competent principals, not being legal entities; but their members may be held as principals if they have acted jointly in the appointment of an agent. In other words, members of such associations may be joint principals.

548. Who may be agent. Any person may be an agent (except infants of tender years, lunatics, imbeciles, and so on). One may be legally incompetent to make a contract, yet act as agent, because the agent's contracts are not his own, but his principal's. An infant is only a medium, or conduit, through whom the transaction passes or flows. Therefore, only the legal capacity of the principal is material in such a case. So far as the agent is concerned, the only requirement on his part is that he possess sufficient physical and mental capacity to exercise the authority delegated to him. A person is disqualified to act as agent under the following conditions:

(a) When the agent has a personal interest adverse to his principal's.

(b) When the agent acts for several principals with conflicting interests.

(c) When the agent and third party have mutual interests that might conflict with the principal's.

(d) When agents do not possess qualifications or licenses required by law, as in the case of attorneys at law, auctioneers, brokers, and so on.

B. How Agency May Be Created

549. In general. An agency may be created (a) by appointment, (b) by ratification, (c) by estoppel, and (d) by neces-

⁴ *Williston on Contracts*, (Vol. 1, p. 444), cited in *Casey v. Kastel*, 237 N.Y. 305, 311.

sity. The first two are by *act of the parties*, the last two by *operation of law*.

550. Agency by appointment. A principal appoints an agent by written, oral or implied contract.

(a) *Agency by written appointment: power of attorney.* When the agent's authority is evidenced by a written instrument, such instrument is known as a *power of attorney*. This is not necessarily the same as a contract. The agency contract, setting forth the rights, duties, powers and liabilities of the parties, may be drawn up separately from the power of attorney, which is but the evidence of the agent's authority. A power of attorney may be *formal*, as in the case of a duly acknowledged instrument under seal, or *informal*, as in the case of a simple letter of authority. *Ten* purposes for which a power of attorney may be given are: (1) to execute commercial paper, (2) to collect debts of a business, (3) to collect dividends, (4) to manage, lease and sell real estate, (5) to sell shares of stock, (6) to solicit and accept subscriptions and collect the proceeds thereof, (7) to acknowledge documents, (8) to institute suit, (9) to appoint subagents, (10) to sign receipts.

(b) *Agency by oral appointment.* Except as noted in sec. 551, an agent's authority may be oral and need not be written.

(c) *Implied agency; marital relationship.* Agency may be implied from the conduct of the parties and the circumstances of the particular case, evidencing an *intention* to create the relationship (as distinguished from an agency *implied by law* in the interests of justice, as in the case of an agency by *estoppel*, which may be declared to exist regardless of the intention of the parties).

Except for the implied agency of a wife in purchasing household necessities (sec. 554), an agency will not be implied from marital relationship alone.⁵

551. Agency by appointment: the statute of frauds. The general provisions of the statute of frauds have already been considered (secs. 182-192). An agency contract may be oral, except when it comes within the provisions of the statute of frauds. For example, an agency contract not to be performed within one year from the date of making must be evidenced by a writing (sec. 183). *If an agent's duties involve making contracts governed by the statute of frauds, must the contract of agency itself be in writing?* The answer to this question depends on the reading of the applicable statute of frauds. For example, in New York the various statutes provide as follows:

(a) Conveyance or assignment of an estate or interest in real property (other than a lease for not more than one year) or of any trust or power affecting real property, must be signed by the party to be charged, "or by his lawful agent thereunto authorized *by writing*."⁶

⁵ *Rodgers v. Saxton*, 305 Pa. 479, 158 A. 166.

⁶ *Real Property Law*, sec. 242.

(b) Contract to sell real property or to lease it for more than one year must be "subscribed by the lessor or grantor, or by his lawful agent, *thereunto authorized by writing.*"⁷

Example: Adams signed Ball's name to the following receipt and delivered it to Chase: "Received of John Chase \$50 deposit on purchase of premises, 140 Third Street, 40 x 100, price \$10,000; cash, \$3000; balance in first mortgage for three years or less." Before a formal contract of sale could be made, Ball sold the property to Darby. In a suit by Chase against Ball, Chase would succeed only if Adams had been authorized in writing to act for Ball. (This would not be true in states where the statute does not require such agency appointments to be in writing.)

(c) Contract for sale of personalty of \$50 value or over must be evidenced by writing "signed by the party to be charged, *or his agent in that behalf.*"⁸ In other words, such an agency contract *need not* be evidenced by writing.

(d) In the following cases the contract must be "subscribed by the party to be charged therewith, *or by his lawful agent.*"⁹ Hence in none of these cases does the agent's authority have to be written, since a writing is *not* specifically required by the statute:

(1) Contracts not to be performed within one year from date of making, or the performance of which is not to be completed before the end of a lifetime.

(2) Special promise to answer for debt, default or miscarriage of another.

(3) Contracts in consideration of marriage.

(4) Conveyance or assignment of a trust in *personal* property.

(5) Subsequent new promise to pay debt discharged in bankruptcy.

(6) Contract to bequeath property or to make testamentary provision.

(7) Contract to establish a trust.

552. Agency by ratification. Ratification, in agency, is the approval of an unauthorized act done by an agent without authority. If one person acts for another without authority or in excess of his authority, such lack of authority may be cured by a subsequent ratification, which may be written, oral, or implied, as by accepting the benefits of an act with full knowledge of the facts. The following rules apply to ratification:

(a) Whatever one may lawfully do he may ratify.

Crimes and torts. Since one cannot lawfully commit a crime, he cannot ratify it. Hence if Brown's bookkeeper forges Brown's name to a check and cashes it, Brown's subsequent ratification will not wash out the crime, though it may render Brown liable on the check. But one may ratify a *tort*, which is a private wrong (sec. 28), so as to assume liability

⁷ *Real Property Law*, sec. 259.

⁸ *Personal Property Law*, sec. 85.

⁹ *Personal Property Law*, sec. 31.

for it; for example, if Allen procures money under false pretenses by dishonestly representing himself to be Brown's agent, Brown may ratify the tort so as to be liable for it. (But this would not cure the crime of obtaining money under false pretenses.)¹⁰

(b) The principal must be competent to ratify. If a person is not competent to act as principal in appointing an agent, he is incompetent to ratify an act done on his behalf. A corporation is not competent to ratify an act performed on its behalf before the corporation came into existence, because one cannot act as agent for a nonexistent principal. However, a corporation can *adopt* such an act so as to become liable on it (sec. 744).

(c) The act must have been done in the name and on behalf of the person who ratifies it. For example, if, without authority, you purport to act for Brown, the act cannot be ratified by Smith.

(d) The ratification must be with full knowledge of the facts. If you knew that I was anxious to sell my automobile for any price it would fetch, and you proceeded to sell the car for me without my knowledge or authority, and by fraudulent representations, and if I then ratified the sale, I would not be liable in a subsequent action for fraud unless I was aware of the fraudulent representations at the time of ratification.

(e) Ratification must cover the entire act. One cannot ratify the favorable portion of an unauthorized act and reject the unfavorable: he must ratify all or nothing.

553. Agency by estoppel. We have already defined the principle of estoppel (sec. 103). If I permit you to pose as my agent, and a third party acts on the belief that you are my agent and extends credit or makes some other sacrifice in dealing with you, the law will prevent or *estop* me from now stepping forward and denying that you are my agent. The effect is the same as if an agency actually existed: to all intents and purposes it exists, because the law will not permit the contrary to be shown.

554. Agency by necessity. An agency by necessity is one implied in law where a situation exists or an emergency arises which makes it necessary to presume an agency as a matter of public policy. Examples are:

(a) The implied agency of a wife to pledge her husband's credit in purchasing necessities for the household.

(b) The implied agency of a child to pledge a parent's credit in purchasing necessities when the parent fails to supply them.

(c) The implied agency created by marine emergencies whereby the

¹⁰ *Daughters of American Revolution v. Schenley*, 204 Pa. 572, 54 A. 366; *Henry v. Heeb*, 114 Ind. 275, 16 N.E. 606, 5 Am.S.R. 613; *Owsley v. Philips*, 78 Ky. 517, 39 Am.R. 258; *Kelchner v. Morris*, 75 Mo. App. 588; *Workman v. Wright*, 33 Ohio St. 405, 31 Am.R. 546; *Henry Christian Bldg., etc., Assoc. v. Walton*, 181 Pa. 201, 37 A. 261, 59 Am.S.R. 36, 636.

master of a vessel may obligate the owner for repairs or towage in a distant port, or may *jettison* (sec. 966) part or all of a ship's cargo.

(d) The implied agency in emergencies to contract for medical, hospital or first aid expenses. Where life, limb and health are at stake as the result of some accident, such as a railroad wreck, and authority from the principal cannot be obtained or time does not permit the delay in procuring it, an executive employee, superintendent or other representative may obligate his principal or employer by incurring the necessary medical, hospital or first aid expenses.

C. Duties and Obligations of Principal to Agent

555. In general. The rights, duties and liabilities of principal and agent as to each other, and the powers an agent possesses in dealing with third parties, depend in large part on their contract. Often, however, there is no express contract between the parties, or else it is silent on questions that subsequently arise. In such cases the law speaks.

If I gratuitously promise to act as your agent, and then change my mind, neither of us becomes obligated to the other. On the other hand, once I embark upon the agency, you are entitled to assume that I will discharge my duties as agent with reasonable fidelity and care. If I fail to do so, I am liable to you for consequent loss, and the fact that my services were gratuitous will furnish no defense.¹¹

Rights and duties being *reciprocal* (sec. 18), the duties and obligations of a principal to his agent represent the agent's rights against his principal; and the duties and obligations of an agent to his principal represent the principal's rights against the agent.

Among the major duties and obligations of a principal to his agent are the duty (a) to *compensate* the agent, (b) to *reimburse* him for expenses, (c) to *indemnify* him against risks, and (d) to pay *damages* for breach of the agency contract. In addition, (e) certain obligations of the principal, or rights of the agent, are secured by an agent's *lien*.

556. Duty to compensate agent. Unless otherwise agreed, or unless the services rendered are obviously gratuitous, a principal must compensate his agent. The amount of compensation depends upon the bargain of the parties or, in the absence of bargain, upon reasonable value based upon custom, nature of services rendered, and so on.

¹¹ *Carmichael v. Lavengood*, 112 Ind. App. 144, 44 N.E. 2d 177, 180.

Examples:

(1) Arthur agrees to supervise the construction of a garage for \$250. The work takes longer than Arthur anticipated. Arthur is nevertheless bound by the agreed compensation.

(2) If, in example (1), nothing were said about compensation, Arthur would be entitled to a reasonable compensation based on custom, experience and the value of his services.

(3) An insurance agent advises the beneficiary of a policy to pay the premium lest the policy lapse for nonpayment by the policyholder. As a result, the beneficiary, on the policyholder's death, collects a substantial payment. If the insurance agent now seeks compensation for his advice, he will not succeed: His services were obviously gratuitous, and without express or implied agreement as to compensation. (See section 1565.)

Contingent compensation. If an agent is hired on the contingency that there is to be no compensation unless a given result is achieved, the agent is bound by such bargain regardless of time expended or the value of his services, unless failure to achieve the result is the principal's fault.¹²

Examples:

(1) Hull is hired to find a purchaser for McLean's yacht at a price of not less than \$100,000. His compensation is to be 10% of the sales price if he is successful. He is unable to find a purchaser. Though he has spent three months of diligent effort and has incurred several hundred dollars in personal expenses in quest of a purchaser, Hull may recover neither compensation nor reimbursement.

(2) A real estate agent hired by a seller found a purchaser on the seller's terms. The agent had signed an agreement not to claim commissions if the deal for any reason fell through. The deal fell through because the seller could not give good title. The agent was entitled to his commissions: Failure to achieve the result was the principal's fault.

Drawing accounts. In the absence of an agreement specifically providing that a drawing account is to be deemed nothing more than a loan or advance to be returned in any event, a drawing account is equivalent to a salary. Thus, if a salesman is guaranteed a drawing account of \$25 a week against commissions to be earned, and he earns no commissions, he need not repay the sums received unless the agreement specifies that the drawing account is in effect a loan or advance to be repaid if not earned.¹³ A salesman is not a debtor to his principal for the deficiency of his commissions; the drawing account is offset only against commissions actually earned.¹⁴

557. Duty to reimburse agent. An agent is entitled to be reimbursed by his principal for all expenses expressly or im-

¹² *Berwin v. Cable Raincoat Co.*, 311 Mass. 483, 42 N.E. 2d 729; *Clarkson v. Standard Brass Mfg. Co.*, 237 Mo. App. 1018, 170 S.W. 2d 407, 414; *Smith v. Duracraft Products Co.*, 75 Ohio App. 556, 62 N.E. 2d 731; *Cauthorn v. Allen*, 184 Okl. 489, 104 P. 2d 247.

¹³ *Miller v. The Blaisdell Machinery Co.*, 83 Misc. 35.

¹⁴ *N.W. Mut. Life Ins. Co. v. Mooney*, 108 N.Y. 119.

pliedly authorized and incurred during the course of the agency.

558. Duty to indemnify agent. A principal must indemnify his agent against risks reasonably and necessarily assumed or to be assumed by him in the conduct of the agency.

Examples:

(1) An agent may be compelled to pay damages or fines innocently incurred in following the principal's instructions. If these were not so obviously illegal as to put the agent on notice of their illegality, the principal must indemnify the agent for losses incurred in assuming such risks.

(2) An agent who acts for an undisclosed principal may become personally liable at the option of the third party (sec. 569). For such risk, the agent may require indemnification, either before or after becoming personally obligated.

559. Agent's right to damages for breach of contract. A principal who violates his contract with his agent sustains the usual penalty of damages for breach of contract, subject to the rule which excludes speculative damage and requires a party to *mitigate* the damage (sec. 240). Thus, an agent under a five year contract who was discharged without cause at the end of the first year cannot collect damages for four idle years without having attempted to procure other employment.

560. Agent's lien. An agent has a lien for reimbursement and indemnity on account of advances, expenses and losses,¹⁵ but not ordinarily for services, except where such lien is specially created by contract. The lien attaches to the principal's money or property *in the agent's hands* in connection with which the advances were made, expenses incurred, or losses sustained; that is, the lien is *possessory* (sec. 1136), not *charging* (sec. 1143).

Example: Jones is about to go abroad. Smith asks Jones to take along a rare book for sale abroad, to reimburse himself, and to remit the balance to Smith. After Jones spends \$748 he receives a cable from Smith revoking the agency. If Jones spent the \$748 because of the agency, he has a lien on the proceeds for reimbursement; otherwise not.

Attorney's lien. An attorney at law, by statute, has a possessory lien on his client's papers to secure payment of fees. However, since a client may always retain new counsel, he may compel the attorney to relinquish the papers, but not until a lien has been judicially declared and fixed by court order.

¹⁵ *Caughlan v. State*, 22 Ala. App. 220, 114 So. 280; *Jessen Liquor Co. v. Phoenix Distillery Co.*, 171 Iowa 505, 153 N.W. 148; *Arushan v. Meshaka* (Mass.), 192 N.E. 162; *Newhall v. Dunlap*, 14 Me. 180, 31 Am.D. 45.

Accountants: worksheets v. clients' books and records. An accountant has no lien on the books and records of his clients.¹⁶ However, a client owns only such papers as originated in the client's office. A public accountant owns all his working papers. This conclusion was reached by the Court in Massachusetts,¹⁷ which held that a public accountant is not an agent but an independent contractor. Working papers, said the court, and also copies of tax returns, are prepared by accountants for their own use and as a basis for their reports: Therefore they belong to the accountants and should be retained by them, because it might be necessary for the accountants to have them "if the accuracy of their work was questioned."

D. Duties and Obligations of Agent to Principal

561. In general. Among the major duties and obligations of the agent to his principal are (a) loyalty and good faith, (b) obedience, (c) skill, care and diligence, and (d) the duty to account.

562. Loyalty and good faith. Unlike most business relations wherein parties deal "at arm's length," an agent's relationship to his principal is "fiduciary," that is, it involves a high degree of faith and trust. Hence an agent owes the highest degree of loyalty and good faith toward his principal. For violation of such duty, an agent is deprived of his right to compensation, reimbursement, indemnification or lien. Thus:

(a) An agent must not serve two masters with conflicting interests. But an agent may represent both buyer and seller where he has nothing to do with the price and merely brings the parties together, as is frequently the case with brokers (see sec. 583).

(b) An agent must not have a personal interest adverse to his principal's; as where a principal instructs an agent to buy certain property which the agent secretly owns himself.

(c) An agent must not engage in a business competing with the principal's, unless this is done with the principal's knowledge and consent.

563. Obedience. An agent must obey his principal's instructions. If his duties are "ministerial" (routine) he must obey instructions to the letter; if discretionary, he must use his best judgment.

¹⁶ *Scott Shoe Machinery Co. v. Broaker*, 35 Misc. 382, 71 N.Y. Supp. 1023.

¹⁷ *Ipswich Mills v. Dillon*, 260 Mass. 453.

Examples:

(a) If an agent is instructed to remit by express and he remits by check, he becomes liable for the loss if the dealer becomes insolvent before payment.

(b) An agent was instructed to remit by mail in \$50 and \$100 bills. Instead, he sent \$5, \$10 and \$20 bills, thus increasing the size of the package, which was lost. The agent was held responsible for the loss.¹⁸

(c) If an agent without authority to do so, pledges his principal's goods, and the principal is unable to release the goods from the pledge because the agent had possession of the documents of title and was ostensibly authorized to pledge the goods (see sec. 599), the principal may hold the agent for damages resulting from the latter's breach of duty. (If the agent pledged his principal's negotiable paper, the principal would in most cases not be bound by such pledge, since an agent's authority to pledge and in-dorse negotiable paper is not usually implied.)

(d) See section 1558, subd. (c).

564. Skill, care and diligence. The degree of skill, care and diligence which an agent must use depends on the nature of the task. Ordinarily, when one undertakes a particular agency, he impliedly warrants that he has the necessary skill and will exercise the necessary care and diligence to perform the task properly. For example, if a certified public accountant or a lawyer undertakes to advise his client in a matter with which he is not familiar, or in which he is not qualified, he is responsible to his client for consequent loss.

Malpractice is the illegal or neglectful practice of one's profession. If a lawyer or accountant undertakes to advise professionally on a matter outside the scope of his knowledge, experience and training, such as in respect to the law or professional practice in another state, he may be liable to his client for consequent loss.

Examples:

(1) A certified public accountant of the State of New York advised a client as to a proper accounting system for the State of Illinois, and in so doing, failed to provide for certain records required by Illinois law. The certified public accountant is liable for consequent damage to his client.

(2) A New York attorney, assuming that the Connecticut law was the same as that in New York, advised his client on the refiling of a chattel mortgage in Connecticut. The refiling was ineffective, and the client lost a \$15,000 lien. The attorney was held liable for the consequent loss.¹⁹

(3) See sections 1568 and 1569.

(4) A depositor leaves two bonds with a bank for sale and credit to his account. The bank, through an irresponsible employee, loses the bonds by mailing them unregistered to another bank. The bank clearly failed to

¹⁸ *Wilson v. Wilson*, 20 Pa. 393.

¹⁹ *Degan v. Steinbrink*, 202 App. Div. 477, 481.

exercise the skill, care and diligence required by the circumstances, and is liable to the depositor for the loss.

An agent is not an insurer of the services he renders, unless he guarantees a result by express contract.²⁰ If, for example, a lawyer fails to win his case, or a physician to effect a cure, neither can be held liable if reasonable skill, care and diligence were exercised.

565. Duty to account. The agent's duty to account is broader than the mere rendering of accounts. It embraces the duty to render unto the principal that which is, or in good faith should be, the principal's. An agent who collects money for a principal should notify the principal promptly of the collection and either remit forthwith or at such time as is customary and agreed upon between the parties.

Intermingling funds. If an agent is permitted to retain the principal's funds for some time, he should keep them in a separate account from his own. If he fails to do so and the intermingled fund is lost, even without his negligence, the agent is liable for the entire loss. In this respect an agent's duty is similar to that of a trustee. (See sec. 1254.)

Secret profits. If an agent directly or indirectly earns or obtains any secret profit or advantage out of his agency, he must account for it (turn it over) to the principal.

E. Agency and Third Parties

566. Principal's liability on contracts generally. A principal is liable to third parties on contracts made by his agent:

- (a) When the contract was expressly or impliedly authorized.
- (b) When the contract, though originally unauthorized, was subsequently ratified.
- (c) When the contract, though neither authorized in the first instance nor subsequently ratified, was made under circumstances from which the third party had a right to assume that the agent was duly authorized. Such circumstances are to be considered in the light of the distinction between general and special agencies.

567. Principal's liability on contract: general agencies. The extent to which a principal is bound by an agent's contracts on his behalf in dealing with third parties depends upon whether the agency is *general* or *special* (sec. 542). On contracts made through a general agent, a principal is liable even when the agent exceeds his actual authority, provided (a) the agent was *apparently* authorized to make the commitment, that is, the unauthorized acts are such as similar agents usu-

²⁰ *Northern Pac. Ry. Co. v. Minnesota Transfer Ry. Co.*, 219 Minn. 8, 16 N.W. 2d 894.

ally have authority to perform, and (b) provided the third party is unaware that the agent is exceeding his authority.

Examples:

(1) *P*, a wholesaler, appoints *B* as his general agent for the sale of flour in Chicago, with instructions not to sell below market price and not to warrant quality. *B* sells to *C* below market price, with a warranty of quality. The flour is not of the quality warranted by *B*. *P* is not only bound by the lower price but by the warranty of quality. *B*, as a general agent, was apparently authorized to act as he did, and *C* was unaware that *B* was deviating from his instructions.

Authority to make collections. Mere authority to sell or solicit does not carry with it a presumption of authority to make collections, unless the agent has possession of the goods or other "indicia" (sec. 405, subd. b) of authority.

Examples:

(1) On July 7 a stranger called at the office of Dunham, a public accountant, exhibited the card of a well-known stationery house, and obtained an order for analysis paper. The next day Dunham received the analysis paper with an invoice payable in thirty days. On July 15 the stranger called and asked Dunham whether he would pay then for the paper. Dunham paid in cash and the stranger receipted the bill. The stranger was a solicitor who received a commission on any order accepted and filled. He disappeared without accounting for the collection. Under the circumstances, the stationery house can collect from Dunham. The stranger had neither possession of the goods sold nor "indicia" of authority.

(2) See question 21 on page 322.

Authority to indorse and cash checks. An agent authorized to make collections has no implied authority to collect anything but money.²¹ If he is given authority to take checks, he has no implied authority to collect and cash them.²²

Examples:

(1) An agent authorized to collect rents received a check payable to the order of the principal, which he indorsed in the principal's name and cashed at the bank. The agent then disappeared with the proceeds. The principal sued the bank. Said the Court: "The authority which Leonard had as agent to collect the rent and transact other business for Beare gave him no legal authority to endorse (the) check for Beare and his endorsement thereof was just as ineffectual to pass title as if he had forged Beare's name."²³

(2) Hoven sold a horse to Turner, with instructions to pay Hoven's agent, who delivered the horse. Turner gave the agent a check to the

²¹ *Lindsey v. Drs. Keenan, Andrews & Allred*, (Mont.), 165 P. 2d 804.

²² *Merchants' & Manufacturers' Ass'n v. First Nat. Bank*, 40 Ariz. 531, 14 P. 2d 717; *Wilson v. Johnson*, 98 Kan. 66, 157 P. 413; *Waldo v. Fuller*, 18 Ohio Cir. Ct. (N.S.) 184; *Kay v. Wayne County*, 274 Mich. 90, 264 N.W. 300.

²³ *Robinson v. Chemical National Bank*, 86 N.Y. 404, 407.

order of Hoven. The agent indorsed Hoven's name on the check, and Turner, at the agent's request, guaranteed the indorsement, whereupon the bank cashed the check and the agent disappeared with the proceeds. As among Hoven, Turner and the bank, the loss falls on Turner. The bank had no right to cash the check on the agent's unauthorized indorsement, and was therefore liable to Hoven; but Turner, who guaranteed the indorsement, is liable in turn to the bank.

Authority to hire subagents and employees. Whether a principal becomes liable to subagents and employees who are hired by a general agent, depends upon whether such delegation of authority is within the actual or apparent scope of the agent's authority (sec. 541); that is, whether subagents and employees have a right to assume that the agent is authorized to hire them. This, in turn, may depend upon such factors as: (1) nature of duties to be performed; (2) necessity of hiring skilled assistance, such as the services of a lawyer, accountant or engineer; (3) trade usage; (4) status of agent, that is, whether the agent is a single individual or a large organization with a staff of assistants, and so on; (5) location of agent with reference to location where services are to be rendered, (that is, hiring a New York lawyer for a Chicago case, which would necessarily imply authority to retain Chicago counsel).

Duties that cannot be delegated. There are certain duties which an agent must perform himself and cannot delegate. Many public servants are in this class.

Examples:

(1) The President of the United States, members of Congress and the judiciary, and numerous other public officials cannot delegate to others certain constitutional functions entrusted to them.

(2) Private agents hired for their special fitness cannot delegate their professional duties to others: a noted surgeon hired to perform a delicate operation must do so himself; a skilled trial lawyer hired to conduct an important lawsuit cannot delegate the task to a subordinate.

Delegation of trust functions. A trustee may delegate routine, but not fiduciary duties. (See secs. 1253 and 1588.)

568. Principal's liability on contract: special agencies. The principal is not liable on any contract negotiated through a special agent (sec. 542) unless the agent has been expressly authorized to make the contract. If a third party dealing with a special agent is in doubt about the agent's actual authority, he should verify it.

569. Principal's liability on contract: disclosed *v.* undisclosed principals. A disclosed principal is one whose identity is revealed by the agent to the third party at the time of the contract. An undisclosed principal is one whose identity is not thus revealed, even though the third party knows that the agent is acting for someone else. When the principal is undis-

closed at the time of the contract and the third party later ascertains his identity, he has the option of holding either the agent or the undisclosed principal, but not both.

570. When undisclosed principal is not liable. There are three situations in which an undisclosed principal is not liable for the acts of his agent:

(1) *Fully executed contracts.* A principal is not liable on a contract which has been fully executed by the agent.

Example: The agent of an undisclosed principal gave his personal notes, which were accepted as payment by the seller of land. This, said the Court, constituted a fully executed purchase contract, so that when the notes fell due and the agent failed to pay, the principal was not liable on the contract though he received the benefit of it.²⁴

(2) *Contracts under seal.* Ordinarily, a principal cannot be bound by a contract under seal unless his name is on it. In some states, however, if the seal is unnecessary to the contract, the undisclosed principal will be liable though his name is not on the contract. An undisclosed principal is liable on a sealed instrument in any event where the statute has abolished the legal effect of a seal.

(3) *Negotiable instruments.* No person can be a party to a negotiable instrument unless he appears thereon to be such.²⁵ However, as pointed out in section 264, when an agent signs for an undisclosed principal and the payee knows it and that the agent does not intend to bind himself individually, the agent, if he has been authorized thus to sign, is not personally liable to the payee; but the principal in such case is not liable, either, since his name is not on the instrument.

571. Principal's liability for agent's torts. A principal is liable for his agent's torts if they are committed during the course of the agent's duties and within the scope of his actual or apparent authority. This is true though the agent, in committing the tort, violated the principal's instructions.

Torts held to be within scope of employment (principal liable): (1) When an agent, to collect from a debtor, threatened unlawful imprisonment. (2) When a floorwalker followed a customer suspected of theft to the street, and forcibly compelled him to re-enter the store. (3) When an agent, with power to remove trespassers, attempted to remove one peaceably, but became involved in an altercation which resulted in wrongful killing. (4) When a subway guard, under the mistaken belief that a passenger had dropped a bad coin in the turnstile, detained and assaulted the passenger. (5) When, in selling merchandise, the agent made fraudulent representations, though instructed by the principal not to do so.

²⁴ *Ranger v. Thalman*, 84 App. Div. 341, affirmed 178 N.Y. 574. See also *Humphrey v. Bussey*, 99 Fla. 1249, 128 So. 841.

²⁵ Uniform Negotiable Instruments Act, sec. 18.

Torts held to be outside scope of employment (principal not liable): (1) When an agent, in collecting a disputed account, made a wilful and malicious assault on a bystander. (2) When an agent shot trespassers under a general authority to remove them. (3) When an agent, to make sales to a city, offered bribes to city officials without the principal's knowledge. (4) When a cashier, without authority or instructions to do so, caused loss to a depositor by negligently and improperly undertaking to draw up legal instruments (bond and mortgage). (5) See section 1573.

Liability for torts: agency by estoppel. A principal may be liable for the torts of a person who is not really his agent, if the principal is estopped from denying the agency.

Example: A department store advertised itself as furnishing dental services through a dentist in charge. Actually the dentist was on his own. A customer suffered injury due to the dentist's negligence in the treatment of her teeth. The court held that the department store was estopped from denying that the dentist was its agent, and was liable for the dentist's negligence.²⁶

572. Principal's liability for agent's crimes. The principal is not liable for an agent's crimes, though committed during the course of the agency, unless the principal authorized, directed, aided or acquiesced in their commission. But a principal may become liable for negligence in hiring a criminal without proper investigation. An employer may be held liable for labor violations by his superintendent or foreman, though he neither authorized, directed, nor knew of the violation.

573. Notice to agent: when binding upon principal. When a principal's liability depends upon his receiving notice, he may be bound by notice given to his agent in respect to matters within the scope of the agency.

Examples:

(1) A third party gave notice to an agent who purchased a note, that it was tainted with usury. This was held to constitute notice to the principal.²⁷

(2) A railroad ticket agent was infected with smallpox. He knew it. This knowledge was also held to be chargeable to the railroad company.²⁸

574. Agent's liability to third parties. In addition to the agent's liability for breach of duties common to all persons (sections 28 to 30), an agent may become personally liable to third parties in various ways connected with his function as agent: .

²⁶ *Hannon v. Siegel-Cooper Co.*, 167 N.Y. 244.

²⁷ *Sheppard v. White*, 78 Ill. A. 428.

²⁸ *Missouri etc. R. Co. v. Raney*, 4 Tex. Civ. A. 517.

(a) *Agent acting for nonexistent or incompetent principal.* If an agent purports to act for a principal who in fact is nonexistent or contractually incompetent (such as an infant in connection with a luxury, or an insane person), the agent himself becomes liable to the third party. (See sec. 1575.)

(b) *Agent acting for undisclosed principal.* As previously noted (sec. 569), an agent acting for an undisclosed principal may render himself personally liable to a third party at the latter's option.

(c) *Misrepresenting extent of authority.* When an agent misrepresents the extent of his authority and a third party, relying thereon, seeks to hold the principal but is unable to do so, the agent may become personally liable to the third party for his misrepresentation.

Example: An agent is authorized by a storekeeper to have the show counters revarnished at a cost not to exceed \$50. He orders additional painting work for the rest of the store at a contract price of \$250. If the agent's acts are held not to be within the apparent scope of his authority, and the painter, in consequence, is unable to hold the principal, he may hold the agent for misrepresenting the extent of his authority.

(d) *Agent's liability for monies wrongfully received.* An agent may likewise be personally liable to third parties for monies wrongfully paid to him through fraud, mistake, or for any other reason which gives the third party a right to recover the money back, provided the agent at the time of demand for the return of such money stands in his original position and has not yet turned the money over to his principal.

(e) *Obligations personally assumed.* An agent may obligate himself expressly in connection with the subject matter of an agency, as in a case where he guarantees the principal's obligation, or where he receives money or property from a third person for his principal, on his personal promise that it will be returned under certain conditions.

(f) *Agent's liability for torts.* An agent is personally liable for any torts committed by him, whether in the course of the discharge of his duties or otherwise. For example, if an agent knowingly commits fraud on behalf of his principal, the agent may be personally liable as well as the principal.

575. Liability of third party to principal. Just as a principal, whether disclosed or undisclosed, is bound by his agent's contracts, so a third party is bound to the principal by the same contracts, whether the principal be disclosed or undisclosed. However, a third party may stipulate in his contract that the person with whom he is dealing represents that he is acting as principal, not as agent; and in such cases the third party will not be liable if the agent is really acting for an undisclosed principal.

Example: Williams, in making a purchase from Brown, fails to disclose the fact that he is acting for Green. Brown has had previous unsatisfac-

tory dealings with Green and does not wish to do business with him. Unless Brown obtains a stipulation in the contract that Williams is not acting for Green, or that Williams is acting for himself only, Brown must deliver the merchandise on Green's request.

576. Liability of third party to agent. The agent's contracts are not his own, but his principal's. Therefore, the third party's liability on such contracts is to the principal, not to the agent. Of course if the third party commits a tort against the agent, such as assault and battery, negligence, libel, slander, and so on, the mere fact that the injury is to an agent does not prevent the latter from redressing his wrong.

F. Termination of Agency

577. How agency may be terminated. An agency may be terminated either by the acts of the parties themselves or by operation of law. With one exception, the principal and agent always have the *power* (though not necessarily the right) to terminate their relationship. With the same exception, the relationship may be terminated by operation of law. The exception relates to agencies "coupled with an interest"²⁹ (see sec. 581).

578. Termination by act of parties. An agency may be terminated by act of the parties in any of the following ways:

(a) *By original agreement between the parties.* The agreement creating the agency may contain a specific provision calling for termination of the agency after the lapse of a given time or upon the happening of a given contingency; or the agency may be terminated by the fulfillment of its purpose, as in the case of an agency to sell a horse, which is terminated by the sale of the horse.

(b) *By subsequent agreement of the parties.* After entering into a contract of agency, both principal and agent may mutually agree to terminate it.

(c) *By revocation on the part of the principal.* A principal generally has the *power* to revoke an agency, even though he has not always the *right* to do so. In the latter event, he would be subject to damages for wrongful revocation.

Example: Adams, agent for Prentice, was about to close an unusually large order for Prentice and to earn a substantial commission thereon, when Prentice revoked the agency, though it still had a month and a half to run. Adams' authority to go ahead with the deal was thereby automatically terminated, since a principal has the power to terminate the agency at any time. Adams may, however, hold Prentice for damages due to the wrongful termination.

²⁹ *D'Amato v. Donatoni*, 105 Vt. 496, 168 A. 564.

A principal may rightfully revoke an agency if the agent violates his duties to his principal (sec. 561).

(d) *By renunciation or abandonment on the part of the agent.* An agent always has the *power*, although he may not always have the *right*, to renounce or abandon his agency. If he renounces in violation of his agreement, he is liable for damages.

An agent may, however, rightfully renounce or abandon his agency when: (1) the principal violates the agency agreement, as by refusing to pay agreed compensation, to repay disbursements, or to indemnify the agent; (2) the agency is gratuitous; or (3) the agency is terminable at the will of either party.

579. Termination by operation of law. An agency may be terminated by operation of law in any of the following ways:

(1) *Illegality of subject matter.* A liquor agency, for example, is terminated by the passage of an antiliquor law; a foreign agency is terminated by a state of war between the principal's country and the agent's.

(2) *Destruction or loss of subject matter.* An agency to sell a horse would be terminated by death of the horse prior to its sale; an agency to sell a gem would be terminated by loss of the gem.

(3) *Death or incapacity of the parties.* The death of a principal automatically terminates the agency; the death of an agent has a like effect. Insanity is in most cases equivalent to "mental death," or a destruction of contractual capacity; hence it would have the same effect as death. Disability may have a like effect. If a prize fighter, after appointing a manager as his agent, lost his arms and legs in an accident, the agency would be automatically terminated.

(4) *Dissolution of business.* Dissolution of a corporation under the law amounts to corporate death and automatically terminates the authority of officers, agents and employees of the corporation. Similarly, dissolution of a partnership terminates the authority of agents acting for the firm.

(5) *Bankruptcy or insolvency.* If a principal is adjudicated a bankrupt, his status as principal is terminated and so, in consequence, is the agency. State insolvency laws may have a similar effect.

580. Contracts providing for "irrevocable agency" and "permanent employment." A contract providing for an "irrevocable agency" is no more irrevocable than any other ordinary contract so far as concerns the *power* of the principal to revoke or of the agent to renounce the agency³⁰; but if the revocation or renunciation is wrongful, it will entail damages for breach of the contract. Likewise, contracts for "permanent employment" are not specifically enforceable, since such an agree-

³⁰ *State ex rel. Everett Trust & Sav. Bank v. Pacific Waxed Paper Co.*, 22 Wash. 2d 844, 157 P. 2d 707, 710; *Cooper v. Cooper*, 206 Ala. 519, 91 So. 82; *Roth v. Moeller*, 185 Cal. 415, 197 P. 62; *Staats v. Mangelsen*, 105 Neb. 282, 180 N.W. 78.

ment is construed as merely an employment at the will of either party, not an employment for life.³¹

581. Agency coupled with interest. An agency coupled with an interest is one which gives the agent an interest in the subject matter of the agency itself, as distinguished from a mere interest in connection with the agency.

Example: If I hire you to make collections for me, either upon salary or commission, you have an interest merely in connection with the agency, or in connection with its proceeds. But if I owe you \$500 and Brown owes me \$1000, and I make you my agent to collect my claim against Brown, with instructions to pay yourself out of the proceeds of the collection and to remit the surplus to me, you have an interest in the *subject matter* of the agency itself, namely, an agency *coupled with an interest*.

Agency as security. The foregoing example illustrates an agency by way of security for the performance of an obligation on the part of the principal. Such an agency cannot be terminated by the principal without the agent's consent. It may, however, be terminated by the principal's death unless the security is supported by a transfer of interest, as by the assignment of an account³² or some other interest "engrafted" on the subject matter of the agency itself.³³

Example: A gives B, a creditor, authority to sell goods and collect rents, and to pay himself (B) the debt A owes him. A dies before the goods are sold or the rents collected. Such death will terminate the agency unless the authority was accompanied by the assignment of an interest in the goods or rents. Even without such assignment, however, A, if he lived, could not terminate the authority without B's consent.

A transfer of interest as security need not be formal; it may be accomplished by wire or even implied.

Example: French, while out on his yacht, runs short of funds and wires Thorne to raise \$3000 on the yacht as security, with authority to sell the yacht if the money is not paid in three months. Thorne raises the money but French, after failing to repay the debt, wires Thorne that the authority to sell the yacht is revoked. The agency being coupled with an interest, the attempted revocation is ineffectual.

Power coupled with duty: escrow agents or holders. An agency coupled with an interest may take the form of a power coupled with a duty, as when an agent is entrusted with property to be held in escrow for the benefit of third parties. In such case, the agency is irrevocable until the terms of the escrow agreement are fulfilled.

Example: The debtor of a bank offered to compromise his indebtedness by the payment of \$2074.10. The state superintendent of banks accepted on condition (1) that the debtor deposit the money in escrow and submit to an audit, and (2) that the Court approve the transaction. After the

³¹ *Arentz v. Morse Dry Dock & Repair Co.*, 249 N.Y. 439.

³² *Shepard v. McNail*, 122 Mo. A. 418.

³³ 2 *Corpus Juris Secundum* 1176.

money was deposited, the debtor died, and his executor demanded return of the deposit. The agency, however, having been created under an escrow agreement, was not terminable by death.

Power of attorney to sell collateral. Creditors, in making loans secured by collateral, frequently require that the deposit of collateral be accompanied by a power of attorney given to the creditor to sell the collateral as agent for the debtor in case the debt is not paid, and to apply the proceeds, or so much thereof as may be necessary, to the payment of the debt. Banks frequently lend money on notes thus secured. Such power of attorney is not terminable by the will of the principal (borrower) alone, or by his death.

582. Notice of termination. When a principal revokes or an agent renounces the agency, the notice required for such termination may be such as is fixed in the agency contract or, if none is specified, reasonable notice under the circumstances. Such notice, however, will not bind third parties unless they, too, receive it. Third parties have a right to assume, unless they are otherwise informed, that the authority of the agent with whom they have been dealing continues to exist. In the absence of notice, they are entitled to hold the principal responsible for acts done by the agent within the apparent scope of his prior authority, even though the principal has actually terminated the agent's authority.

Necessity of notice to third parties where principal dies. Ordinarily, the principal's death automatically revokes the agent's authority (sec. 579). Whether a third party, unless notified, is bound by such termination, is a question on which the courts of the country are not in entire agreement. The majority of states hold that he is,³⁴ a minority that he is not.³⁵

Examples:

(1) A landlord appointed an agent to collect rents. Later, he died. Thereafter a tenant, unaware of the landlord's death, paid his rent to the agent, who absconded with it. The tenant was forced to pay rent over again to the executor.³⁶

(2) The payee of a negotiable note indorsed it in blank and delivered it to an agent for collection. The maker paid the note while it was in the agent's possession after the payee's death, and without knowledge of such death. The court held that such payment discharged the debt.³⁷

G. Brokers

583. General nature and distinctions. The general function of a broker has already been defined (sec. 545, subd. (b)). Al-

³⁴ This, also, is the view adopted by the American Law Institute (*Restatement, Agency*).

³⁵ Including Missouri, Nebraska, Ohio, Oklahoma and Pennsylvania.

³⁶ *Farmers Loan & Trust Co. v. Wilson*, 139 N.Y. 284.

³⁷ *Deweese v. Muff*, 57 Neb. 17.

though a broker, broadly speaking, is an agent, his functions may be distinguished from those of other agents.

Brokers v. ordinary agents: "Bought and sold notes." Every broker is an agent, but not every agent is a broker. An ordinary agent usually acts for but one principal, whereas a broker acts as a negotiator between two or more parties to a transaction, frequently binding them by a "bought and sold note."

Brokers serving conflicting interests. As with agencies generally, a broker must not serve two masters with conflicting interests. For example, he may act for both buyer and seller to the point of bringing them together; but if he is hired by the one to negotiate the purchase, and by the other to negotiate the sale, he cannot well discharge his duties of loyalty and good faith toward both by procuring the highest price for the seller and the lowest price for the buyer. Hence a broker in such a position will have no claim against either buyer or seller, regardless of services rendered.

Broker v. factor. Though both broker and factor may be agents to sell, a broker, unlike a factor, is not usually entrusted with possession, control and disposition of the property concerned, nor may he bind the principal by buying or selling the property in his own name.

Brokers are special agents. A broker has no authority, except with the principal's consent, to change any of the principal's terms, such as price, time of payment, rate of interest, and so on; nor, ordinarily, has he the implied authority to make warranties or to sell on credit.

584. Kinds of brokers. There are numerous types of brokers, depending on the nature of the brokerage handled. Among the most common types of brokers are: (a) real estate brokers, (b) stockbrokers, and (c) insurance brokers.

585. Real estate brokers. A real estate broker is one authorized to negotiate the purchase or sale of real property. He cannot conduct his business without first procuring a brokerage license. The license must be in force throughout the entire period during which services are rendered.

Example: A broker spent many months in consummating a transaction. He was licensed when hired, also when his efforts culminated successfully; but his license had run out in between, and was not renewed for several weeks. *Held*, he was barred from recovering his commissions.³⁸

Right to commissions: necessity of contract. Regardless of the value of his services, a broker, in the absence of a contract of hiring, express or implied, is not entitled to commissions.³⁹ "Where there is no employment

³⁸ *Bendell v. De Dominicis*, 251 N.Y. 305.

³⁹ *Peebles v. Sneed*, 207 Ark. 1, 179 S.W. 2d 156, 158; *Klipfel v. Bowes*, 109 Colo. 17, 120 P. 2d 959; *Galloway v. McKinley*, 73 Ga. App. 381, 36 S.E. 2d 485; *Consolidated Realty Co. v. Graves*, 291 Ky. 456, 165 S.W. 2d 26; *Case v. Harrison*, 192 Miss. 531, 6 So. 2d 582, 586; *A. J. Meyer & Co. v. Schulte* (Mo.) 189 S.W. 2d 183, 189; *Williams v. Engler*, 46 N.M. 454, 131 P. 2d 267; *Foreman*

or binding contract for the payment of commissions and the broker acts as a mere volunteer, he is not entitled to compensation for his services, although such services are the efficient cause of bringing the parties together and result in a sale or other contract between them."⁴⁰

Examples:

(1) Lowenthal employed Oppenheimer to sell certain real estate. Oppenheimer brought the property to the attention of prospective purchasers, Barnett and another, who bought the property and in so doing, told Lowenthal, the owner, that Gregory, another broker, had brought about the sale. The seller, acting on such belief, paid commissions to Gregory. Oppenheimer, the first broker, sued the purchasers. The court, in dismissing the complaint, held that the purchasers "intended to dispense with Oppenheimer for the sole purpose of having Gregory get the commissions; but they had a legal right to do this. Oppenheimer did not represent them, and they were under no legal obligations to him."⁴¹

(2) See section 1582.

Lien. A real estate broker ordinarily has no lien, since he is not vested with possession of the property, but is hired to buy or sell. Moreover, real property is not usually subject to a possessory lien (sec. 1136).

"Subject to prior sale." Real estate brokers are usually hired subject to the understanding, express or implied, that authority is automatically terminated in case of a prior sale. (This does not apply to an exclusive brokerage, that is, where the principal agrees to hire no other broker.)

"Ready, willing and able." A broker is not entitled to a commission unless the customer he produces is ready, willing and able to meet the seller's terms.

"Procuring cause." When various brokers claim to have contributed to the result, only the broker who has been the *immediate procuring cause* of the transaction is entitled to commissions.

Seller's inability to give good title. A seller's inability to give good title does not excuse him from paying his broker's commission, unless it was so agreed in good faith between seller and broker.

"No commission unless deal consummated." When the contract contains a provision that "should the deal not be consummated and title not passed for any reason whatever, there shall be no commission considered earned," or similar language, the owner is not thereby excused from paying commissions if he arbitrarily and without reason refuses to consummate the sale in accordance with the terms he gave the broker.⁴²

586. Stockbrokers. A stockbroker is one employed to buy and sell shares of stock and securities generally for customers who thus employ him. He differs from a dealer in securities

v. Reynolds, Ohio App., 58 N.E. 2d 688; *First Trust Joint Stock Land Bank of Chicago, Ill., v. Ferguson*, 187 Okl. 48, 104 P. 2d 427; *Guenther v. Equitable Life Assur. Soc. of U.S.*, 23 Wash. 2d 65, 159 P. 2d 389.

⁴⁰ 12 *Corpus Juris Secundum* 135-136.

⁴¹ *Oppenheimer v. Barnett*, 131 App. Div. 614.

⁴² *Stern v. Gepo Realty Corporation*, 289 N.Y. 275.

in that the latter acts as an independent contractor, not as an agent, and therefore owes no fiduciary duty to the customer, except such as may be imposed by statute. Stockbrokers are frequently, though not necessarily, members of a securities or stock exchange.

Stock bought on margin: stockbroker's right to sell. When a stockbroker buys stock for a customer and carries it for him on margin, it is impliedly agreed, in the absence of express provision to the contrary, that if the stock depreciates, the "margin" shall be replenished and kept good upon demand, and upon failure to do so, that the stock may be sold upon reasonable and customary notice.⁴³

Stockbroker's right to repledge. The right of a pledgee, including a stockbroker, to repledge a customer's securities is discussed in sec. 1540. The rule has been summarized as follows: "A broker who has bought stock for a customer with money advanced by himself and who holds it in his own name as pledgee . . . may, so long as he has not been paid or tendered the amount of his advances, repledge it to the extent of his lien thereon as security for his own debt to a third person without being guilty of conversion or breach of contract, provided the broker has the stock under his control, and can resume possession by paying the amount borrowed thereon, not exceeding the amount owed by the customer . . ." ⁴⁴ Pledging stock with a bank as security for a loan, with the right to withdraw the same, does not put the stock out of control of the broker.⁴⁵

Stockbroker's right to transfer or break up certificate. When stock is deposited with a broker as collateral to secure a purchase on margin, the broker, to facilitate repledging or selling the collateral in case it becomes necessary to cover the margin, has a right to transfer the collateral to a nominee selected by him. For the same reason, the broker is not required to keep or return the identical stock certificate pledged, so long as he has available at all times and returns to the customer a certificate for the same number of shares as that pledged. (See secs. 1586 and 1587.)

Penalty for pledging or disposing of customer's securities without lien. If a customer's securities have been paid for in full so that the stockbroker has no lien on them, and the broker pledges or disposes of such securities without the customer's consent, or if, having a lien on them, he pledges or disposes of them for a larger amount than the customer owes, the broker is guilty not only of conversion, but also, in most states, of a felony. In New York, for example, he would be subject to a fine of not more than \$5000, imprisonment for not more than two years, or both.

When broker becomes insolvent: rights of customer as to deposited securities. When a stockbroker becomes insolvent and is adjudicated a

⁴³ *Gruman v. Smith*, 81 N.Y. 26, 28; *Stenton v. Jerome*, 54 N.Y. 480; *Krinsky v. Whitney*, 315 Mass. 661, 54 N.E. 2d 36; *Durant v. Block*, 11 N.J. Misc. 919, 930; 169 A. 848, affirmed 113 N.J. Law 509, 174 A. 889; *Goldfarb v. Bruner*, 46 Ohio App. 213, 188 N.E. 362; *Markham v. Jaudon*, 41 N.Y. 235.

⁴⁴ 12 *Corpus Juris Secundum* 78-79.

⁴⁵ *Harris v. Friedman*, 245 Mass. 479, 139 N.E. 788.

bankrupt, cash customers who can identify their securities may reclaim them. All other customers share ratably ahead of general creditors, but subject to claims having a higher priority.

Bucketing. Stockbrokers are strictly forbidden to trade for their own account against their customers' orders. Such practice, known as "bucketing," constitutes a felony, conviction of which is punishable by fine and imprisonment.

Stock exchange transactions. Under the Securities Exchange Act of 1934 no stockbroker may effect a transaction in any security on any national securities exchange, unless such security is registered under the act.

Over-the-counter securities. No stockbroker may deal in or attempt to sell over-the-counter securities on an interstate basis, unless he has duly registered under the Securities Exchange Act.

587. Insurance brokers. An insurance broker is one who acts as middleman between insurer and insured. He is usually under no employment by any special company but solicits insurance from the public, and having secured an order, places it with a company selected either by the insured directly or by the broker acting as the insured's implied agent for that purpose. (See sec. 1003.)

H. Auctioneers

588. Definition. An auction is a public sale of property to the highest bidder. An auctioneer is a person authorized and licensed to conduct an auction.

589. Auctioneer's status as agent. An auctioneer, in making a sale, is primarily the seller's agent. As such, he owes the usual duties of an agent to his principal: loyalty, good faith, obedience to instructions and a proper degree of skill, care and diligence in the discharge of his duties. Once the hammer falls, however, the auctioneer also becomes the purchaser's agent. When he enters a memorandum of the sale in his notebook, he binds the seller on behalf of the purchaser; and when he accepts a deposit, he is responsible therefor to the buyer if the seller refuses or fails to complete the sale. Both seller and buyer are bound by the auctioneer's announcement as to the identity of the property and the terms and conditions of sale.

590. Authority of auctioneer. "An auctioneer is a special agent, and without further authority than that which comes from his position as auctioneer he cannot bind the parties by any contract other than that which is actually made, and a

contract which is beyond his authority is not binding on the owner." ⁴⁶

However, an auctioneer has certain powers which are necessarily implied from the nature of his duties. He may determine the point at which the highest bid is deemed reached, and he may close the bidding by accepting the bid. He may bind the parties by notations in his memorandum book, and he may accept and hold deposits and final payment on the sale, for the account of the seller and to the credit of the purchaser.

On the other hand, an auctioneer's powers are subject to definite limitations. Being a special agent, he may not depart from the specific terms of sale. He has no authority to warrant the property he sells. Unless otherwise authorized, he must accept only cash in payment. He has no implied authority to delegate his power to sell.

591. Manner of making and accepting bids. Bids are usually made orally, in the hearing of others; but cases have supported bids spoken privately to the auctioneer, or by wink, nod or sign. Secret signs between bidder and auctioneer are forbidden.

Acceptance of a bid may be by any established means, usually by the falling of a hammer.

592. Withdrawal of bid. As previously noted (sec. 119), bids are mere offers to buy. They are not binding unless accepted. Hence a bidder may always withdraw his bid before it is accepted.

593. Withdrawal of property. "Until the hammer falls and a bid is accepted . . . the seller may withdraw his property from sale; and he may withdraw it before any bidding, even where the sale is without reserve." ⁴⁷

594. "Chilling" and "puffing," effect of. To "chill" a sale is to stifle or discourage bidding. Any practice which prevents fair, free and open bidding vitiates the sale.

"Puffing" is bidding without intention to purchase, for the purpose of raising the price. Puffers are sometimes employed by sellers in questionable auction sales. Generally, puffing is forbidden by law. Like chilling, it vitiates the sale, being a species of fraud. A puffer may not resort to law to compel

⁴⁶ 7 *Corpus Juris Secundum* 1248.

⁴⁷ 7 *Corpus Juris Secundum* 1253.

payment for his services, since the law will not encourage one who assists in a sham.

595. Licenses and other regulations. Many states require auctioneers to procure a prescribed license. Among the more common state and municipal regulations governing auctioneers are the following:

Posting bond against damages sustained through dishonesty or fraud in conducting an auction sale.

Responsible seller. Ordinances frequently require that the seller must have been in an established business for a minimum period prior to sale.

Night auctions. State statutes prohibiting night auctions are designed to prevent the sale of fake jewelry and gems in the glitter of artificial light.

Records. State statutes generally require auctioneers to keep full records of their transactions with persons on whose behalf sales are conducted, the names and addresses of buyers, collections and proceeds of sales, and similar information. These records must be open for police inspection.

I. Factors

596. In general. We have already briefly referred to the nature and function of a factor or commission merchant (sec. 545, subd. g). Generally, his rights, duties and liabilities are similar to those of other agents. Certain rules particularly applicable to factors or commission merchants are worthy of note. These relate to the factor's power to sell, pledge or mortgage the owner's property, or to trade or exchange it for other property; the factor's duty to insure the principal's property and to account to the principal; and the factor's lien.

597. Power to sell and collect. An ordinary agent sells in the name of his principal, not his own. He may or may not have express or implied authority to collect (sec. 567). A factor, however, having possession of the merchandise he sells, or of the documents of title to the merchandise, is often the ostensible owner of the merchandise, and therefore, unless forbidden by contract or custom, has authority to sell his principal's goods in his own name, and to collect the proceeds, subject to his duty to account therefor to his principal.

Power to trade owner's property for other property. Since a factor's power is to sell, he has no implied power to barter or trade his principal's goods for other goods.

Del credere function. Del credere agencies (sec. 545, subd. i) are most commonly found in businesses which employ commission merchants or agents whose relatively independent financial status enables them to guar-

antee the accounts of their customers upon the usual arrangement for higher commissions.

598. Factor's acts: rights of third parties. Under the common law, if a third party bought goods from an agent who was not authorized to sell, he ran the risk that the principal might repudiate the sale and reclaim the goods. If, in such cases, the agent had in the meantime disappeared, or was unable to respond in damages, the loss would fall on the buyer. The hardship of this rule led to the general adoption of statutes known as "factor's acts." These provide in substance (see sec. 405) that if a factor or other agent is entrusted with the possession of goods, or of documents of title to them (such as bills of lading, warehouse receipts, custom house permits, and so on), for purposes of sale or as security for advances, such factor is deemed to be the true owner of such goods or documents of title, so far as concerns innocent third parties who are unaware of the true ownership. Thus, third parties who give money or negotiable instruments or other written obligations in payment of such merchandise, or as an advance on the security of it, are protected against a subsequent claim by the true owner that the agent was not authorized to make the sale or pledge, though such may have been the fact. In short, owners in such cases are estopped from denying the factor's authority to sell or pledge.

599. Limitation upon power to pledge or mortgage. Not all states are agreed on what facts will estop the owner from reclaiming his goods. This is especially true of unauthorized pledges. Some states hold that if a factor is authorized to sell only, mere possession of the goods by the factor is not enough to justify an innocent pledgee in believing that the factor is also authorized to pledge the goods. Generally, a factor's power to pledge or mortgage the owner's merchandise is limited to situations involving money advanced by the factor in connection with the goods, or claims involving other sums due him, or money advanced by third parties to enable the factor to buy the merchandise for his principal. The factor has no power to pledge his principal's goods for his own individual debts, and if he does so, the owner may reclaim the goods free from the pledge.⁴⁸

⁴⁸ *Imperial Valley Long Staple Cotton Growers' Ass'n v. Davidson*, 58 Cal. App. 551, 209 P. 58; *Tropical State Bank v. Sunshine Motor Co.*, 137 Fla. 703,

Notice of factorship. Factors' acts, as a rule, do not protect persons who have notice of the factorship.

Goods obtained through fraud or theft. When the agent or factor obtained possession of the goods by theft, or with the preconceived idea of defrauding the owner, a pledgee (such as a pawnbroker, for example) is not protected by a factor's act: The owner may reclaim his property without reimbursing the pledgee.

Negotiable paper. Authority to sell negotiable paper does not imply authority to pledge it. The owner may reclaim such paper, even from an innocent pledgee, when there was no authority to pledge it.

Owner's right to redeem. In some states, the owner is given a right to redeem property pledged by a factor, even though the pledgee was ignorant of the factorship, but only upon reimbursement of the money advanced.

Example: The owner of a diamond ring entrusted possession of it to an agent for sale. The agent pawned the ring. The owner, tendering the amount of the loan, demanded the ring regardless of the contract between the factor and the pawnbroker. The Court sustained the owner: The factor's contract was good as against everybody but the true owner.⁴⁹

600. Duty to insure. It is the duty of the factor to insure the goods when such obligation is imposed upon him by custom or usage, or by the principal's instructions, or by agreement implied from a course of dealing. In such cases, if the factor fails to use reasonable prudence or diligence to effect the insurance, or fails to inform his principal of his inability to effect it, he becomes liable as insurer himself.

601. Duty to account. A factor or commission merchant owes a special duty to his principal or consignor in the matter of keeping and rendering accounts. Generally, he has complete possession and control of the principal's goods. He arranges its disposal, and he receives the proceeds therefrom. Frequently he buys the merchandise for the principal in the first instance and then sells it without the principal's ever having seen it. The law therefore imposes upon a commission merchant the duty of keeping regular and accurate accounts of all his transactions on behalf of the principal. He must give the principal the fullest opportunity to inspect these accounts.

602. Factor's lien. A factor has a general lien on goods consigned to him by his principal, or on the proceeds of such goods,

188 So. 595; *International Trust Co. v. Webster Nat. Bank*, 258 Mass. 17, 154 N.E. 330; *De Bates v. Searls*, 52 S.D. 30, 216 N.W. 586, affirmed 52 S.D. 603, 219 N.W. 559; *Jacob E. Decker & Sons v. Milwaukee Cold Storage Co.*, 173 Wis. 87, 180 N.W. 256.

⁴⁹ *Mann v. R. Simpson & Co.*, 286 N.Y. 450.

for all commissions, advances and expenditures properly incurred in the course of the relation of principal and factor. (See sec. 1138.)

J. Employer and Employee

603. Agent v. servant or employee. The distinction between an agent and a "servant" or "employee" is not easy to draw. In theory, an agent may bind his principal by contract; a servant may not. In practice, employees frequently bind their employers by contract, and the terms *agent* and *employee* are used interchangeably. However, an agent usually has broader authority and responsibility than an ordinary employee.

604. Transition in status of labor. The old master-and-servant concept of the common law has largely vanished. The relationship is no longer domestic: the servant is no longer a menial or apprentice attached to the master's household. The relationship, governed entirely by contract, has become highly impersonal. Corporate "masters" employ hundreds of thousands of "servants" who are personally unknown to the corporate heads. Trade unions have largely supplanted the domestic arrangements of apprenticeship. Industrial unions have grown up to supplement trade unions as instrumentalities for collective bargaining.

605. Rights, duties and obligations. Whether an employee acts independently, or through a trade union or industrial union, the rights, duties and liabilities of employer and employee are governed by the contract of hiring; but such contracts must not conflict with the numerous labor statutes, state and Federal, which have been adopted on the ground of public policy. The doctrine of *respondeat superior*—let the master respond in damages for his servants' torts—still applies, as it does in agencies generally, provided such wrongs are committed during the course of employment; and for such wrongs, the employee is equally liable with the employer. However, the fellow-servant rule (that if an employee is injured through the negligence of a fellow servant, the latter only is liable) has been abandoned. Likewise, it is no longer the rule that an employee, to recover against his employer for injuries, must show negligence on the part of his employer and freedom from negligence on his own part. These doctrines of the common law have been generally abolished by statutes dealing with employer's liability and workmen's compensation (sec. 608).

606. Social legislation. The last generation or two has seen a vast increase in labor legislation, both Federal and state. Such legislation, because it has come to affect society as a whole, is frequently termed "social legislation." It has concerned itself chiefly with factory conditions, employer's liability and workmen's compensation for industrial injuries and occupational diseases, the establishment of a minimum wage, child labor restrictions, protection of women in industry, protection of the right to collective bargaining, and "social security."

607. Factory conditions. An employer is obligated by law to furnish his employee a safe and healthful place in which to work. This means that he must provide the proper mechanical safeguards where the employment is hazardous, proper sanitary conditions, and competent fellow employees who will not expose workers to drunken, reckless or incompetent fellow workers.

608. Employer's liability and workmen's compensation. As stated, the old doctrines of the common law restricting an employer's liability to his employee for injuries sustained while at work, have been abolished. The Federal Government and practically every state have passed some form of insurance against industrial hazards. These statutes recognize that when an employee is injured during the course of his employment, compensation for his loss must be assumed as a burden upon the industry, and must be paid regardless of negligence. Many states provide state insurance funds. All of them provide for medical attention for the injured worker, and all grant death benefits, and varying awards for varying periods of incapacity from injuries sustained while at work. Some states provide compensation for occupational diseases.

609. Minimum wage. In 1937 the United States Supreme Court, reversing its previous position on the subject, sustained the constitutionality of a state statute prescribing a minimum wage for women, thereby opening the way for a general adoption of minimum wage legislation. *The Fair Labor Standards Act of 1938*, generally called the *Wage-Hour Law*, was designed "to fix a floor below wages and a ceiling above hours of labor," and to put an end to child labor. One section fixes a minimum wage for employees engaged in interstate commerce or the production of goods for interstate commerce. Another section

provides that no employee shall work more than a certain number of hours per week (the number gets down to a net average of forty), unless he is paid overtime wages. Another section provides that "No producer, manufacturer, or dealer shall ship in interstate commerce any goods produced in any establishment situated anywhere in the United States in or about which any oppressive child labor has been employed." The constitutionality of the *Wage-Hour Law* has been upheld in a decision by the Supreme Court reversing its previous position on the subject.⁵⁰

610. Child labor. Child labor laws were originally introduced in this country in conjunction with compulsory education laws, prohibiting employment of children under a given age during the school term. These were supplemented by factory laws limiting the employment of children as to age, hours and overtime. Court decisions from time to time have declared various child labor laws unconstitutional. As a result, a child labor amendment to the United States Constitution has been pending for a number of years, awaiting approval by the requisite number of states. In the meantime, as noted in section 609, the *Wage-Hour Law* established an important child labor provision in the field of interstate commerce, which was sustained by the Supreme Court.

State statutes regulating child labor have been generally adopted. Characteristic is section 69-a of the New York *General Business Law*, which prohibits the sale of goods, wherever made, if manufactured or produced in or for a factory or by industrial homework with the aid of child labor; a "child" being defined as a person under sixteen. Further restrictions are embodied in the Labor Law, governing the hours of labor, in various industries, of children between the ages of sixteen and eighteen.

611. Women in industry. For a long time it was held that women, like men, should be "free" to bargain independently with their employers as to hours, conditions of employment and wages, and that any attempt to legislate on this subject was unconstitutional as an interference with "freedom of contract." However, practically all states now have laws regu-

⁵⁰ *United States v. Darby Lumber Company*, 312 U.S. 100. This decision reversed the previous position of the court in *Hammer v. Dagenhart*, 247 U.S. 251. (See section 59.)

lating the hours of work for women. Most of these laws have been passed as necessary to the health and safety of women. They have therefore survived constitutional attack.

612. Collective bargaining. Organization of labor into unions for the purpose of collective bargaining has been attended by considerable friction and industrial disturbances, involving strikes and labor disputes generally. Labor has sought to protect itself by the establishment of "the closed shop," where only workers who are already members of a labor union can be employed. The employers have sought to maintain "the open shop," where no restrictions are placed upon them and where they can hire nonunion men if they please. A compromise between the two is the "union shop," where workers need not belong to a union to get a job, but must join after they are hired. In many cases, employers have encouraged "company unions," allegedly to foster co-operation and limit friction between capital and labor. Industrial unions have opposed the formation of company unions, as efforts to undermine the independence of labor.

613. Courts, injunctions and "yellow-dog" contracts. For years, labor organizations sought unsuccessfully to curb the power of the courts to issue injunctions in labor disputes. They likewise fought, with ultimate success, to outlaw the so-called "yellow-dog" contracts, or agreements by workers to refrain from joining outside unions as long as they are employed. In 1932 Congress passed the *Norris-LaGuardia Anti-Injunction Act*. Under this act, "yellow-dog" contracts cannot be enforced in a Federal court, nor may Federal courts issue injunctions to prevent workers from striking, picketing, holding mass meetings or encouraging other workers to strike, except that an employer may secure an injunction in a Federal court if he can prove, among other things, (a) that he will suffer substantial and irreparable injury if an injunction is not issued; (b) that unlawful acts are threatened and will be committed unless restrained; and (c) that public officers charged with the duty to protect his property are unwilling or unable to furnish adequate protection. If a person is accused of contempt of court for violating a labor injunction, he may demand trial before another judge than the one issuing the temporary injunction; and he may likewise demand a jury to hear and determine the issues.

614. **National Labor Relations Board.** In 1935 Congress passed the *National Labor Relations Act*. This act seeks to safeguard the right of labor to bargain collectively, by creating a National Labor Relations Board. The Board has the power to prevent interference by employers with the workers' right to organize or to bargain; to prevent employer domination through a company union; to prevent discrimination by an employer against a worker for labor union activities; to conduct elections among workers to determine employee representation; and to decide whether in a given case the appropriate union for collective bargaining shall be the employer unit, the craft or trades unit, the plant unit, or any subdivision of these units. The constitutionality of this act has been upheld by the United States Supreme Court.

Taft-Hartley Act. The Taft-Hartley Act, adopted in 1947, grew out of alleged abuses under the National Labor Relations Act. Among its provisions are the following: (1) Labor unions must give 60 days' notice before going out on strike; (2) employers may sue unions for breach of contract; (3) unions must make reports on money taken in and what was done with it; (4) Communists are prevented from holding union offices, and union officers must take oath that they are not Communists; (5) unions are prohibited from spending money or making contributions in political campaigns for Federal offices; (6) employers are denied a "union shop" (sec. 612) unless a majority of the workers vote for it; (7) the "closed shop" (sec. 612) is outlawed; (8) the Federal Government, in industries deemed vital to national welfare, may get a court order restraining a strike for several months while settlements are attempted.

615. **Social security.** The Social Security Act, passed by Congress in 1935, and amended in 1939, seeks to establish throughout the United States uniform safeguards against the hazards of poverty, old age and unemployment. In addition it seeks to promote public health and child welfare by co-operative action with the different states of the Union. Ordinarily such uniform action in the different states would have to be achieved through uniform legislation adopted by all the states, as in the case of the uniform Negotiable Instruments Law. However, as a short cut, the Federal government accomplished the same result by an ingenious use of the taxing power, and by grants-in-aid to the states on condition that they co-operate with the Federal government.

(a) *Old age pensions.* The Federal government extends aid to states which have adopted a pension system for needy persons of sixty-five years of age and over. It promises to give one half of the benefits paid. Con-

tributions are limited to needy persons. They do not exceed \$40 per month per person.

Old age *pensions* must not be confused with the system of old age *insurance* established by the Social Security Act.

(b) *Old age and survivors' insurance.* This is a compulsory system of old age insurance for all employees in the country, except domestic servants, agricultural workers, government employees, officers and crew of a vessel, parent, husband and wife or minor child of an employer, or employees of charitable organizations. Insurance revenues for old age payments are obtained by a payroll tax imposed on both employer and employee, who must contribute in equal proportions. The amount of the ultimate insurance annuity is based on the individual's salary, and the number of years it has been received. The annuity becomes a matter of right, as with any other system of insurance, and is not a government gratuity. The law fixes \$85 per month as a maximum annuity and \$10 per month as a minimum. In the case of salaries exceeding \$3000 annually, there is no tax on the excess.

The act now affords protection to survivors of workers, as well as to workers themselves. Originally, the act called for benefits to the workers only, on their reaching sixty-five years of age, and a lump sum payment on the worker's death, which went to the estate; and that was all. The 1939 amendment provided continuing protection for survivors of deceased workers, including dependent widows and children and, in some cases, dependent parents.

(c) *Unemployment insurance.* This part of the Social Security Act seeks to encourage states to set up systems of unemployment insurance in accordance with certain prescribed standards. If a state passes such a law conforming to the prescribed standard, the Federal government undertakes to collect a special payroll tax from employers (not to be confused with the old age insurance tax). In each state adopting compulsory insurance, ninety per cent of the tax collected by the Federal government in the state is credited to that state. Employers of eight or more persons only are subject to this tax. The employee is not taxed under this plan. The unemployment insurance fund thus established is maintained by the Federal government and may be invested only in Federal obligations. Unemployment insurance payments to an individual depend upon the length of his previous employment.

(d) *Child welfare and other provisions.* This part of the Social Security Act provides outright grants of money to the states for child welfare and public health. It "matches" the funds set aside by states to help needy, dependent children, to provide for the care and treatment of crippled children, to assist the needy blind, and to help to establish a system of mothers' pensions.

The United States Supreme Court has upheld the constitutionality of the Social Security Act.

Questions and Problems for Review

1. What is meant by the term *agency*? NY Nov. 1926 (5)
2. Smith owns several stockyards. He puts Green in charge of

one of them with instructions to hire only a certain number of men. Green hires more than this number of men. Is Smith liable for their wages? Explain. *NY June 1921 (12)*

3. Explain the difference between an attorney at law and an attorney in fact. Write out a form of power of attorney to sign checks. *NY June 1922 (6)*

4. Differentiate an attorney at law and an attorney in fact. Name *five* purposes for which a power of attorney may be given. *NY Nov. 1934 (9)*

5. (a) Distinguish between an attorney in fact and an attorney at law. (b) State what is meant by a bought and sold note. When and by whom is it used? *NY May 1927 (3)*

6. What is a factor? What is a broker? *NY June 1918 (12)*

7. Define (a) foreign factor, (b) agent by procuration. *NY Nov. 1928 (3)*

8. A is principal; B is A's del credere agent. A sells C, on credit, merchandise of the value of \$5000. C does not pay A. A sues B to recover the \$5000; B's defense is that the action is unenforceable as his agreement with A was unenforceable under the statute of frauds. Is B's contention correct? Give reasons. *NY Nov. 1927 (11)*

9. State which of the following classes of persons may be competent principals: (a) infant, (b) corporation, (c) married women, (d) insane person, (e) unincorporated club. *NY May 1927 (6)*

10. How may an agent be appointed? *NY Nov. 1932 (8)*

11. H, S's agent,* negotiated with A for the sale of K's realty. When the terms were agreed on, A paid H \$50 on account and H signed K's name to the following and delivered it to A: "Received of A \$50 deposit on purchase of premises, 140 Third Street, 40 x 100, price \$10,000; cash, \$3000; balance in first mortgage for three years or less." Before a formal contract of sale could be entered into, K sold the realty to W. A sued S† for money damages for breach of contract. Can he recover? Give reasons. *NY Nov. 1929 (15)*

*So in the original. Obviously a typographical error which should read, "H, K's agent," and so on.

†Likewise an obvious typographical error. Should read, "A sued K," and so on.

12. What transactions of agency require an agent's appointment by an instrument under seal? Name three exceptions to this rule. *NY Nov. 1931 (10)*

13. Enumerate the ways in which an agent may incur personal liability. *NY Oct. 1933 (2)*

14. What redress has a principal in case his agent pledges (a) the goods of the principal, (b) the negotiable paper of the principal? *NY Apr. 1934 (8)*

15. What is the duty of a commission merchant toward the consignor with respect to the rendering of accounts? *NY June 1919 (3)*

16. A certified public accountant of the State of New York advised a client as to a proper accounting system to be used in the State of Illinois. Because of ignorance on the part of the said certified public accountant, of the laws of Illinois, he failed to provide for certain records required by the Illinois law. Is the certified public accountant responsible for damages resulting therefrom? *NY June 1924 (5)*

17. A firm of Smith & Jones delivered two U.S. Liberty bonds of \$1000 each to the cashier of their bank, with instructions to sell the bonds and deposit the proceeds to their credit. The cashier, intending to send the bonds to another bank to be sold, placed them in an envelope, sealed it, marked it for registration and affixed the necessary postage. The envelope thus marked was entrusted to an employee of the bank, with instructions to take it to the post office and register it. When the employee arrived at the post office, the registration window was closed, so he dropped it as regular mail without obtaining a receipt. The bonds were lost or stolen. Is the bank liable to Smith & Jones for the amount of the two bonds? Explain. *NY June 1924 (11)*

18. Has a commission merchant the power to pledge or mortgage property consigned to him? Can he trade consigned property for other property? Explain. *NY Jan. 1925 (14); NY June 1920 (7); NY Jan. 1919 (3)*

19. May a commission merchant sell, in his own name, goods sent to him on consignment? Explain. *NY Jan. 1924 (12); NY June 1919 (2)*

20. On July 7, 1930, a stranger called at the office of Dunham, a public accountant, exhibited the card of a well-known stationery house and obtained an order for analysis paper. On the next day the analysis paper was received by Dunham, together with an invoice payable in thirty days. On July 15, 1930, the stranger called and asked Dunham whether he would pay then for the paper. Dunham paid in cash and the stranger receipted the bill. It developed that the stranger was a solicitor who received a commission on any order accepted and filled and that he had disappeared without accounting for the collection from Dunham. Can the stationery house collect from Dunham for this paper? *AI Nov. 1930 (2)*

21. Zilberman was a wholesale dealer in hardware. He employed Bromberg as his agent to take orders for him. Bromberg took an order from Friedman for certain hardware, which was shipped to Friedman. Later, Bromberg, having no authority to do so, as was afterwards shown in court, called on Friedman, demanded and obtained payment, giving Friedman a receipt signed in the principal's

name by Bromberg as agent. Bromberg failed to pay this money over to Zilberman, and Zilberman sued Friedman. Friedman's defense was that he paid Zilberman because he paid his agent. Show whether or not Friedman's defense is a good defense. *NY May 1931 (14)*

22. A was appointed agent by a power of attorney by P for the purpose of making collections. Among the receipts taken in on a particular day was a check payable to the order of P for \$500. A indorsed the check and took it to the X Bank, whose teller gave A \$500. When P learned this, he sued the X Bank for the proceeds of this check. The bank's principal defense was "The act of the agent is the act of the principal."

(a) Is this a good defense? Explain.

(b) Could P recover the \$500? Explain. *NY Nov. 1930 (13)*

23. Hoven sold a horse to Turner, to be paid for upon delivery at Turner's residence. Hoven instructed Turner to pay Hoven's agent who would deliver the horse. Upon delivery, Turner gave the agent a cheque drawn to the order of Hoven. The agent endorsed Hoven's name on the cheque and Turner, at the agent's request, guaranteed the endorsement. The agent cashed the cheque and disappeared. Does the loss fall upon Hoven, upon Turner, or upon the bank at which the agent cashed the cheque? *AI May 1933 (5)*

24. State what is meant by the term "doctrine of undisclosed principal." Give an example of how it applies. State one class of contracts to which this doctrine is never applicable. State three occasions when the principal will be held liable for the frauds committed by the general agent. State what is meant by a del credere agency, and state whether a contract creating this relationship is required by the statute of frauds to be in writing. *NY May 1926 (4)*

25. Who is liable and to what extent in cases of (a) negligent torts by servants, (b) willful torts by servants? *NY June 1932 (3)*

26. William White, a depositor in the First National Bank of Woodhollow, consented to loan \$2000 on a first mortgage, and during the negotiations referred to the subject in speaking with the cashier of the bank. The cashier asked who was going to act as attorney in the matter and White said that he had no counsel. Thereupon the cashier offered to draw up the bond and mortgage for a fee of \$6 and to attend to the other necessary details. White accepted his offer and paid the fee of \$6. The papers were drawn and the money paid over. A short time afterward White discovered that the mortgagor did not have title to the property; subsequently White lost the amount loaned on the mortgage. He then began action against the bank to recover his loss. Will he succeed? *NY Jan. 1923 (4)*

27. What are the obligations of an agent to third parties? *NY Jan. 1920 (10)*

28. Mention five ways by which the relations between principal and agent may be terminated. *NY May 1930 (9)*; *NY Nov. 1927 (9)*

29. A landlord appointed an agent as collector of rents. He continued to collect rents regularly up to the time of the landlord's death. One of the tenants, unaware of the landlord's death, paid rent thereafter to the agent, who absconded with the money. Can the landlord's executor collect the rent from the tenant? Give reasons for your answer. *NY Nov. 1931 (13)*

30. Prentice made a valid contract with Adams whereunder Adams was to sell Prentice's goods on commission during the period from January 1, 1931, to June 30, 1931. Adams made satisfactory sales up to May 15, 1931, and was then about to close an unusually large order when Prentice suddenly and without notice revoked Adams' authority to sell. Can Adams continue to sell Prentice's goods during the unexpired term of his contract? *AI Nov. 1931 (2)*

31. Davis borrowed money from Harrison and gave him as security a power of attorney to collect future rents from Davis' tenants.

(a) Would this power of attorney be canceled by Davis' death prior to the repayment of the loan?

(b) Can a tenant who knows of Davis' death discharge his obligation for rent accrued prior thereto by paying Harrison? *AI Nov. 1934 (5)*

32. French owned a yacht on which he was accustomed to take long trips. While on such a trip he telegraphed to Thorne instructing Thorne to telegraph to him \$3000, in consideration of which French authorized Thorne by such telegram to sell the yacht for the purpose of repayment to Thorne, if French did not pay the \$3000 within three months' time. On the receipt of French's telegram, Thorne immediately telegraphed the money to French. The money was not paid at maturity and Thorne attempted to sell the yacht. Whereupon French wired to Thorne revoking his authority to sell the yacht. What effect has this revocation? *NY May 1926 (5)*

33. A, debtor of the X Bank, in liquidation, offered to compromise his indebtedness by the payment of \$2074.10. The state superintendent of banks agreed to consider this offer on condition that the debtor deposit the money in escrow and submit to an audit, and on condition, also, that acceptance of this offer be approved by the court having jurisdiction of the liquidation. The deposit was made and the audit completed, but the debtor died prior to acceptance of the offer by the superintendent. The debtor's executor immediately demanded the return of the escrow deposit. Is he entitled to it? *AI Nov. 1932 (6)*

34. Frank, who owned an apartment house, borrowed a sum of money from Sloane, giving Sloane a power of attorney to collect rents of the apartment house and apply them to reduction of the

loan until paid in full. Frank died before the loan was repaid. Was the power of attorney revoked by such death? *AI Nov. 1929 (13)*

35. A real estate agent, on behalf of the seller, finds a purchaser for the property, but after the contract is signed, the purchaser refuses to accept the deed, because the seller cannot give a perfect title. Is the agent entitled to commission? Explain. *NY Jan. 1917 (5)*

36. Has a stockbroker the right to sell stock bought by him for a customer on margin, to reimburse himself for advances made to the customer? Give reasons. *NY May 1925 (12)*

37. State to what extent the broker may legally use as collateral, security belonging to a customer, which came into his possession under the following conditions: *X & Company* are stockbrokers doing a general business of buying and selling securities for customers' accounts. Customer *Y* places his order with *X & Company* to buy 1000 shares of *Union Pacific Company* stock, depositing with *X & Company* at the same time \$25,000 in part payment for the stock. *X & Company* pay \$50,000 for the stock advising *Y* of their purchase for his account. To what extent, if any, are *X & Company* at liberty to use the 1000 shares of stock as collateral for a loan to them at the bank? Answer fully. *NY Jan. 1922 (3)*

38. What authority has an auctioneer? *NY Jan. 1921 (2)*

39. Is a commission merchant to whom goods are sent on consignment bound to insure them if sent uninsured by consignor? *NY Jan. 1920 (2)*

40. *A*, in the course of his employment, is injured by the negligence of a fellow employee. The employer is not insured under the provisions of the workmen's compensation law. At the trial of *A*'s suit against him, the employer makes the objection that the workman should have applied for compensation to the State Industrial Commission and offers to show that the accident was due to *A*'s own negligence. Is the employer's objection valid? Explain. *NY Jan. 1917 (13)*

CHAPTER VII

Partnership

616. Scope of chapter. In this chapter we consider the nature and characteristics of a partnership; the various types and classes of partnerships and of partners; how partnerships may arise; the rights, duties, powers and liabilities of partners, not only in respect to the firm name, good will, capital and firm property, but also as to one another and in their dealings with third persons on behalf of the firm; how a partnership may be dissolved, together with the various partnership remedies and duties involved in such dissolution; and a summary of the law governing limited or special partnerships.

A. Nature and Characteristics of Partnership

617. Law governing partnership: Uniform Partnership Act. As with other branches of substantive law, a uniform statute embracing certain standard rules governing partnerships, known as the Uniform Partnership Act, has been adopted by the states shown in the table on pages 12-13. The rules of the common law apply to all partnership questions not covered by the Uniform Act or by separate state statutes.

618. Definition and characteristics of partnership. The Uniform Partnership Act defines partnership as "an association of two or more persons to carry on as co-owners a business for profit." The essential characteristics of a partnership are:

(a) *Association as individuals.* A partnership is an association of persons as individuals, not (as in the case of incorporators) an association whose individualities become merged into a corporate entity. Although a partnership may be treated as an entity for certain purposes, it remains, for most purposes, an association of individuals as such.

(b) *Voluntary association.* Persons cannot be forced into partnerships. Parties have a right to select the persons with whom they are to associate themselves in business. The fiduciary character of the relationship between partners and the risk of liability by each partner for the acts of the

other partners within the scope of the partnership emphasize the highly voluntary character of the association.

Examples:

(1) A partner may assign his interest in the firm to an outsider, but he cannot, by doing this, make the assignee a partner without the consent of the other members of the firm.

(2) A partner may bequeath his interest in the firm, but such bequest transfers merely an unliquidated interest in the firm, not the right to become a partner.

(c) *Co-ownership.* Partners must have a *proprietary interest*, not only in the profits as such, but in the enterprise which is the subject-matter or object of the partnership. (See sec. 620.)

(d) *Association must be one for profit.* If the object of the association is anything other than profit, it is not a partnership. For example, joint enterprises for charitable, eleemosynary, religious, or other nonprofit purposes, cannot be called partnerships.

(e) *Mutual agency of partners.* Each partner is agent for the others and for the firm in respect to all partnership acts. Hence partners occupy a fiduciary relationship toward one another, with everything that such relationship implies (secs. 562 and 666).

(f) *Mutual liability of partners.* Since each partner, as to partnership acts, is agent for the others and the firm, each partner, as well as the firm, is a principal as to all partnership acts, in tort or in contract. This makes each partner financially responsible for such acts; if his copartners and the firm become insolvent, he may become exclusively responsible.

619. Who may be partners. Generally speaking, any person who is competent to make a contract may become a partner. Therefore, the only limitations upon a person's capacity to unite with others in a partnership are those which apply to contracts generally.

Infants as partners. Infants may be partners, subject to their right to disaffirm (sec. 137), but once debts are incurred, the infant may not withdraw his investment until creditors are paid, unless remaining assets are sufficient to pay such debts.

Corporations as partners. The view of a majority of our courts¹ (al-

¹ *Central R., etc., Co. v. Smith*, 76 Ala. 572, 52 Am.R. 353; *McTigue v. Arctic Ice Cream Supply Co.*, 20 Cal.A. 708, 130 P. 165; *South Carolina, etc., R. Co. v. Augusta Southern R. Co.*, 107 Ga. 164, 33 S.E. 36; *Marine Bank v. Ogden*, 29 Ill. 248; *Breinig v. Sparrow*, 39 Ind.A. 455, 80 N.E. 37; *Mestier v. A. Chavalier Pavement Co.*, 108 La. 562, 32 S. 520; *Williams v. Johnson*, 208 Mass. 544, 95 N.E. 90; *White Star Line v. Star Line of Steamers*, 141 Mich. 604, 105 N.W. 135; *Franz v. Wm. Barr Dry Goods Co.*, 132 Mo.A. 8, 111 S.W. 636; *Burk v. Concord R. Co.*, 61 N.H. 160; *Peo. v. North River Sugar Refining Co.*, 121 N.Y. 582, 24 N.E. 834; *Merchants' Nat. Bank v. Standard Wagon Co.*, 65 Oh.St. 559 mem, 63 N.E. 1124 mem; *Municipal Pav. Co. v. Herring*, (Okl.), 150 P. 1067; *Salem-Fairfield Tel. Assoc. v. McMahan*, 78 Or. 477, 153 P. 788; *Boyd v. American Carbon Black Co.*, 182 Pa. 206, 37 A. 937; *Huguenot Mills*

though some states have held to the contrary²) is that a corporation, from its very nature, does not have the power to become a partner (sec. 878). However, so far as third parties are concerned, a corporation may be liable as a partner when it enters into an arrangement that amounts to a partnership. In short, a corporation may become a partner by estoppel.³ (See sec. 1595.)

Partnerships as partners. A partnership or firm may enter as such into partnership with other firms, provided all firm members consent. Thus, the *AB Company*, consisting of *A* and *B*, may become a partner of the *CDE Company*, consisting of *C*, *D* and *E*, on consent of all five. In adjusting profits and other rights and liabilities in respect to each other, the two firms will be treated as separate entities, but as to outside creditors of the combined partnership, *A*, *B*, *C*, *D* and *E* will be liable as members of a single firm.

620. True test of partnership. The true test of partnership is the intent of the parties. Such intent may be expressed in an agreement or implied from the circumstances. The Uniform Partnership Act provides that, except for partnership by estoppel (sec. 646), persons who are not partners as to each other are not partners as to third persons. Since persons are not partners as to each other unless they have intended to create a partnership, the important question to be determined is: When and under what conditions may parties be deemed to have intended a partnership as to each other?

621. Profits as test of partnership. The common law adage, "Those who share profits must likewise share losses," is no longer regarded as valid, for persons may share profits in various ways without becoming partners. The *sharing of profits, as such, by reason of a proprietary interest therein*, is regarded as a more accurate test. To arrive at this test, it is sometimes necessary to consider a variety of factors.

622. Co-ownership. Mere co-ownership does not of itself establish a partnership, though the co-owners share profits.

Example: The co-owners of a profitable apartment house are not necessarily copartners.

623. Sharing gross income. The sharing of gross returns does not of itself establish a partnership. Indeed, the Court .

v. Jempson, 68 S.C. 363, 47 S.E. 687; *Mallory v. Hanaur Oil Works*, 86 Tenn. 598, 8 S.W. 396; *Planters' Oil Co. v. Gresham*, (Tex. Civ. A.) 202 S.W. 145; *Wilson v. Carter Oil Co.*, 46 W.Va. 469, 33 S.E. 249.

²*Butler v. American Toy Co.*, 46 Conn. 136; *Allen v. Woonsocket Co.*, 11 R.I. 288.

³*Catskill Bank v. Gray*, 14 Barb. 471, 479; *Moore v. Thorpe*, 133 Minn. 244, 158 N.W. 235, 239.

has held that it does not even furnish *prima facie* evidence of a partnership.

624. Sharing profits: in general. The sharing of net returns or profits does furnish *prima facie* evidence of a partnership. But no such inference may be drawn if such profits are received in payment of a debt, as interest on a loan, as wages, as rent, as an annuity on behalf of a deceased partner, or as consideration for the good will of a business.

625. Sharing profits in payment of debts: loan *v.* investment. If one advances money or credit to a business in consideration of a share of the profits, this does not necessarily make one a partner of the business. Whether such advance constitutes a loan or an investment depends upon the intent of the parties. Such intent may be express, as by the terms of an agreement, or implied, as from circumstances.

Example: Lamb & Son, doing business as Alpha Paper Works, become insolvent. They assign their assets to their creditors under an agreement by which certain creditors, as trustees for all, are to carry on the business in its old name, pay out profits to creditors until all debts are paid, and then return the business to Lamb & Son. Such arrangement constitutes a trust, not a partnership, since profits are to be divided, not as such, but in payment of a debt. Thus, if the trustees, as such, were to issue a note and then fail to pay it, the trustees would be responsible, not as partners, but as trustees; that is, their liability would extend only to assets held by them as trustees, not (as in partnership) to the personal assets of the partners where partnership assets prove insufficient.

Terms and conditions justifying inference of loan. Following are some of the terms and conditions that may justify an inference that the advance was intended as a loan, not an investment:

- (1) The money advanced is returnable in any event.
- (2) The party advancing money or credit is given no control or managerial power, except as security to protect the advance.
- (3) Stipulation against liability.
- (4) Taking a note for the amount of the advance.

Terms and conditions justifying inference of partnership. Following are some of the terms and conditions which may justify an inference that the advance was intended as an investment, not a loan:

- (1) Repayment of the moneys advanced is contingent upon profits.
- (2) The party advancing money or credit is given control or managerial powers, not as security, but in conjunction with duties.
- (3) No stipulation against liability for losses.
- (4) No instruments or evidences of debt.

626. Profits as interest on loan. A creditor may receive a share of profits not only in payment of his debt, but also by way of interest, "and still he would not be a partner of such

business. Instead of having an interest in common with the business, his interest would more often be in opposition to it.”⁴ Such profits, though they may exceed the lawful rate of interest, are not construed as usury unless interest at the lawful rate is guaranteed in any event. “Since advances made to a partnership or joint adventure by one of its members are subject to the hazards of the business or undertaking, any rate of interest that may be agreed upon for such advances is legal; but if the other partners or joint adventurers bind themselves absolutely to repay such advances, thus exempting the lending partner from risk of loss, only legal rates may be charged.”⁵

627. Profits as wages or bonus. Employees who share profits in the form of wages or bonus are not on that account partners. Thus, a manager hired at a fixed salary plus 15% of the profits is not on that account liable to creditors as a partner. However, his contract may require him to conduct himself in such manner that third parties may have reason to believe that he is a partner. To protect himself against such liability, such employee, before signing his contract of employment, would be well advised to request provisions in the contract to the following effect:

- (a) That the employee is hired as such and is not a partner.
- (b) That profits are received as salary or bonus, not as profits.
- (c) That the employee is not required to contribute to capital or losses.
- (d) That the employee is to receive a minimum guaranteed salary in any event.
- (e) That the employee's name is not to appear on firm stationery or anywhere else in such way as to suggest membership in the firm.
- (f) That the employee is not to be held out in any other way as a partner.

628. Profits as rent. Ordinarily, the leasing of premises for a share of profits as rent, or in addition to rent, does not make the landlord liable as a partner. However, if the agreement, whether designated as a “lease” or by any other name, gives the owner of the property the rights, duties and powers of a partner, so that he clearly appears to be such to outsiders, he may be held liable as a partner.

629. Other forms of nonproprietary profits. In addition to the foregoing forms of nonproprietary profits, the Uniform

⁴ *Roach v. Rector*, 93 Ark. 521, 526, 123 S.W. 399.

⁵ 66 *Corpus Juris* 195.

Partnership Act provides that no presumption of partnership shall arise from the receipt of profits as an annuity to a widow or representative of a deceased partner, or as consideration for the sale of the good will of a business or other property by installments or otherwise.

630. Sharing losses. Under the common law, an agreement to share profits implied an agreement to share losses. This rule, as noted, no longer prevails where profits are not shared as such. However, although an agreement to share losses does not necessarily constitute a partnership, a true partnership does imply an agreement to share losses.

An agreement providing that profits are to be shared ratably by all but losses only by some, is valid and binding upon the parties to the agreement but not upon outsiders unaware of the arrangement.

Example: *A, B and C*, partners, agree that *C* shall not be liable for losses. *X*, an unpaid creditor unaware of the arrangement, sues all three for the debt. He is entitled to judgment against all three, but *A* and *B* must make good to *C* for any loss he thereby sustains.

Where two persons embark upon a venture in which one indemnifies the other against loss, the result is not necessarily a partnership.

Example: In *Rosenblatt v. Weinman*,⁶ one party advanced money to another for the purchase of stock upon an agreement that profits were to be divided but losses borne by the purchaser. The Court held that this did not constitute a partnership but a contract of indemnity against loss, the consideration for the indemnity being the privilege of sharing in the profits.

As noted in sec. 710, a special or limited partner may limit his losses to the amount of his investment.

631. Documentary and other evidence to support partnership. The available evidence to support the foregoing tests of partnership necessarily varies with the facts of each case. Documentary evidence is the most satisfactory, but circumstantial evidence is frequently decisive. The evidence to look for in a typical situation is suggested in sec. 1601.

632. Partnerships as between the parties *v.* partnerships as to third parties. The test of a partnership as between the parties themselves is not necessarily the same as the test applied in deciding whether third parties may invoke the doctrine of estoppel against an ostensible partner (sec. 646). Evidence of

⁶ 225 Pa. 200.

any real intent to form a partnership may be wholly lacking, yet parties may so conduct themselves as to lead third parties to believe, and reasonably so, that a partnership exists. In such a situation, persons may have no claim upon one another as partners, yet may be chargeable as copartners in respect to third parties.

Examples:

(1) John Phillips, a poor Scottish immigrant, founded a small business which grew to a large manufacturing establishment. His four sons worked with him and largely contributed to the growth of the business. Subsequently, one of the sons filed a bill for an accounting as a partner. Upon the trial, the following developed: (a) Although the business had been conducted in the name of John Phillips, the father, in a few instances bills were made out to John Phillips & Sons; (b) the sons devoted all their time and attention to the business, received no regular salaries, but received funds for their support, which were charged to them separately; (c) the father told people that his sons were interested in the business; (d) in accordance with a Scottish custom, it was understood that everything belonged to the father during his life and that the business and property would be left to his children on his death; (e) upon repeated occasions the father repudiated the suggestion of a partnership, saying on one occasion, "Na, na. I will ha' nae sons for partners. Damn them. They would put me out of the door." The Court dismissed the son's bill, holding that while the facts might have spelled out a partnership as to third parties, there was insufficient evidence of an intent to form a partnership so far as concerned the parties themselves.⁷

(2) Stanley loaned Gorham \$750 "for use in the business of heating, ventilating, etc." In consideration of this loan and Stanley's services in securing sales, Gorham agreed to divide the net profits of the business equally with Stanley. It was agreed that the money loaned by Stanley was "especially for use in the business and for no other use whatever." The loan was secured by collateral. Gorham was to be allowed \$1000 for his services in managing the business (which was to be carried on in Gorham's name). Hackett rendered services and furnished materials for the business upon Gorham's request. Thereafter he sued Stanley as a partner. The Court, in giving judgment to Hackett, pointed out that "persons may be partners as to third persons, although not so as between themselves, and although the contract of partnership contains express provisions repudiating such a relation."⁸

633. Differences between partnership and corporation. Partnerships differ from corporations in at least five important respects: (1) as to liability for debts of the business; (2) as to liability of the owners of the business for the acts of one an-

⁷ *Phillips v. Phillips*, 49 Ill. 437.

⁸ *Hackett v. Stanley*, 115 N.Y. 625, 631.

other; (3) as to continuity of the business and the effect of death, bankruptcy or the sale of one's interest in the business; (4) as to the necessity of obtaining permission to do business; and (5) as to the right to practice a profession. (See sec. 1593.)

634. Advantages of partnership. Offsetting its disadvantages as contrasted with the corporate form of doing business, partnerships present the following advantages: (1) relative liberty and equality of action in place of formal requisites for voting and elections at meetings of stockholders and directors, (2) lighter tax burdens, (3) relative freedom from public supervision, annual reports, and so on, and (4) freedom to unite professional skills in fields forbidden to corporations, as in the practice of law, medicine, architecture, and so on. (See, also, sec. 729.)

635. Risks of partnership. Since the chain of partnership is no stronger than its weakest link and any partner may become liable for the acts of all, a prospective partner must weigh the following risks:

- (a) One's own financial ability to withstand and survive reverses.
- (b) The financial resources of prospective copartners.
- (c) The age and health of prospective copartners. (Death dissolves a partnership; ill health of a copartner may handicap or ruin the firm.)
- (d) Integrity of prospective copartners. (Equal access to firm funds and other assets, together with the power to borrow, may, if one partner is dishonest, lead to the ruin of all.)
- (e) Ability, capacity, training, skill and experience of prospective copartners. (Enthusiasm is no substitute for qualifications.)
- (f) Disposition of prospective copartner and his ability to get along with others. (Dissension frequently leads to dissolution.)

636. Partnership *v.* joint venture. In a partnership, persons associate as co-owners for the continued prosecution of an enterprise for profit. In a joint venture, there is merely co-ownership for a given limited purpose, without the usual powers, duties and responsibilities that go with a partnership. In the following situations, (a) is a joint venture, (b) a partnership:

(a) *A* and *B* unite their money and services in purchase and resale of a certain lot of machinery for their joint profit.

(b) *A* and *B* enter into an agreement whereby each contributes \$2000 and his services in establishing and carrying on a shoe store for their joint profit.

637. Partnership *v.* joint-stock association. A joint-stock association is an unincorporated enterprise resembling a partnership in that it consists of an association of individuals as such rather than as shareholders of an entity such as a corporation. Members of a joint-stock association, like members of a partnership, are liable for its debts, and may sue and be sued together as individuals. However, joint-stock associations resemble corporations rather than partnerships in that they may issue shares of stock against capital, enjoy the corporate advantage of continuous succession, and manage their affairs through directors and officers. (See sec. 730.)

B. Partnership Classifications

638. Kinds of partnerships. Partnerships are either (1) *ordinary* or (2) *limited*. The latter are also known as *special* partnerships. They are discussed in secs. 710 to 720, inclusive.

Ordinary partnerships are either *universal* or *general*. A universal partnership, like a universal agency, is rare, being largely theoretical.

639. General *v.* special partnerships. General partnerships are created for the usual partnership purposes. The term *general partnership* is commonly used in contradistinction to the term *special partnership* (sec. 710). General partnerships are either *trading* or *nontrading*.

Trading partnerships are those formed for ordinary business or industrial purposes.

Nontrading partnerships are those formed for professional or quasi-professional purposes (law, accountancy, brokerage, and so on).

The practical effect of the distinction between trading and nontrading partnerships is that third persons are entitled to assume that members of a trading firm have wider authority than members of a nontrading firm.

640. Kinds of partners. Partners may be classified as general, limited or special, secret, silent, dormant and nominal.

641. General partner. A *general* or *active* partner is one who takes an active part in the management of the business and whose liability is unlimited. General partners may not only be members of an ordinary partnership, but also of a special or limited partnership; that is, the term *general partner* may indicate those members of a limited partnership whose powers, authority and liability are not limited, as they are in

the case of the special partners who are members of the firm.

642. Limited or special partner. A *limited* or *special* partner is a member of a limited partnership whose powers, authority and liability are limited by statute, in contrast to those of the general partners who are members of such firm.

643. Secret (undisclosed) partner. A *secret* partner is one whose connection with the firm is not disclosed. He may be active in the conduct of the business, and if his connection with the firm becomes disclosed, third parties may hold him liable, like any other general partner. A secret partner is sometimes known as an *undisclosed* partner. His liability is similar to that of an undisclosed principal (sec. 569).

Example: Tompkins and Sheehan form a manufacturing firm, conducted in Tompkins' name. Tompkins buys manufacturing material on credit from a seller who knows nothing of the partnership. Later the firm fails. The seller, on learning the facts, may hold Sheehan as well as Tompkins.

644. Silent partner. A *silent* partner is one who has no voice in the management. Unless he is also a special partner, his liability for firm obligations is the same as that of any other partner.

645. Dormant partner. A *dormant* or *sleeping* partner is one who is both secret and inactive. His liability or liabilities to third parties are the same as those of a general partner, if his connection with the firm is discovered. The fact that he is a dormant partner does not prevent him from asserting himself as an active partner and taking part in managing the firm's business, unless he is prevented from so doing by the partnership agreement.

646. Nominal (ostensible) partner. A *nominal* or *ostensible* partner is one who appears to the world as a partner and who may be charged with the liabilities of a partner whether or not he has an actual interest in the firm.

Partner by estoppel. A nominal or ostensible partner is sometimes known as a *partner by estoppel*. This is another illustration of the doctrine of equitable estoppel referred to in sec. 103. Thus, where a person, intentionally or through culpable negligence, holds himself out or permits himself to be held out as a partner, he may share liability as a partner (without sharing profits) to anyone thereby misled. Where such holding out is public, he renders himself liable as a partner whether anyone has been misled or not.

647. Subpartner. A *subpartner* is a person who forms a partnership with one of the partners, to share, with the latter,

his interest in the firm. The arrangement is a joint venture (sec. 636) rather than a partnership, and the subpartner, by his arrangement, does not become a member of the main firm.

C. How Partnerships May Arise

648. In general. As already indicated, a partnership may be created by contract, express or implied, or by estoppel. An express contract of partnership may be oral or written. It need not be written except when the statute of frauds applies. A written contract governing the rights, duties and powers of the partners is known as "articles of copartnership."

649. Articles of copartnership. Many a business firm, successful in other respects, has foundered for lack of a full agreement among the partners in respect to matters that normally arise in the course of a partnership business. The articles of copartnership should err on the side of resolving at the outset every possible point of difference. For a list of provisions recommended for inclusion in the *articles*, see sec. 1605.

650. Implied contracts of copartnership. Wholly apart from express contracts of copartnership and from partnerships by estoppel, persons may so conduct themselves as to create a partnership by the established standards of legal intent, though actually unaware that they have entered into a contract of copartnership.

Example: In *Sullivan v. Sullivan*,⁹ seven persons associated themselves together to manufacture cheese at a factory owned by three of them, who received a certain sum for the use of the factory. The association adopted no name, and was known by several different names. The expenses and also the losses, if any, were to be paid first, and then the net profits were to be divided among the seven persons, each to receive his proportionate share. There was no conscious desire or intent to form a partnership as such. The Court held, however, that the parties had entered into a contract of partnership.

D. Rights, Duties, Powers and Liabilities of Partners: In General

651. How fixed and determined. The rights, duties, powers and liabilities of partners are determined by the articles of copartnership, and, in the absence thereof, by general rules of law. These rules may relate to (1) the attributes and assets of a firm, (2) the partners in respect to one another, and (3) the firm in its dealings with third parties.

⁹ 122 Wis. 326.

E. Rights, Duties, Powers and Liabilities of Partners:**(1) Firm Attributes and Assets**

652. Firm attributes and assets: in general. The rights, duties, powers and liabilities of partners are governed in large part by the attributes and assets of the partnership, which must be first considered before discussing the specific rights, duties, powers and liabilities of partners. These attributes and assets include: Firm name, good will, capital, and firm property.

653. Firm name. A firm name may consist of the actual names of all or of one or more of the partners, or of a fictitious name. The law places no restrictions on firm names except as to registration and misleading firm names.

654. Registration: fictitious firm names. For years, statutes have forbidden the use of fictitious names unless a certificate is duly filed disclosing the true parties interested. Such statutes apply to individuals and copartners alike. (See sec. 43, "Business licenses," and so on.) The statutes of some states go further and require the filing of registration certificates for all partnerships. In New York, for example, it is a misdemeanor to conduct a partnership business not only under a fictitious name, but under any name, unless a certificate is duly filed setting forth the partnership name, the full names of all partners, their residences and business addresses, and the names of any who may be infants.

655. Misleading firm names. Statutes commonly provide that no person may conduct business in the name of a partner not interested in the firm; and when the designation "and company," "and Co." or similar designation is used, it must represent an actual partner. Two exceptions are generally made:

(1) Where an established business continues to be conducted by some or any of the partners, or their assignees, appointees or successors in interest.

(2) A partnership may use the name of a pre-existing firm or corporation that has been conducting business in the state and that has either discontinued or is about to discontinue its business within the state, where a majority of the members of the pre-existing firm or their survivors are members of the new firm, or where consent in writing to the use of such name has been given by such majority or their survivors or (in the case of a pre-existing corporation) by stockholders owning a majority of the stock. In such cases, a certificate must be duly filed, showing the pertinent facts as to the old and new partners.

Similarity of names. A firm must not use a name so nearly like that of a business already in existence as to mislead the public.¹⁰ Where it does, the firm already in existence may procure an injunction against the use of the name, together with any damages sustained.

656. Right to hold property in firm name. Formerly, a firm could not hold real or personal property or sign firm contracts in the firm name; all firm property had to be held and all firm contracts signed in the names of the partners as individuals. This is no longer the law. To this extent, a partnership is an "entity."

657. Suits in firm name. Unlike a corporation, which is a true entity, partners generally can neither sue nor be sued in their firm name, but must sue or be sued in their individual names. In some states, however, a partnership that has a president or treasurer may sue or be sued in the name of such officer. In other states, the statute specifically permits a partnership to sue or be sued in the firm name.¹¹

658. Disposition of firm name upon dissolution. When a firm dissolves, the firm name may be disposed of in the following manner: (a) If no provision is made as to the use of the firm name, any partner may use it provided the public is not misled; (b) the right to use the firm name may be sold as a business asset, or a retiring partner may give or sell to a continuing partner or partners the right to use the former firm name; (c) upon death of a partner, the Court may order a sale of the firm's good will and assets, in which event the firm name must be accounted for.

659. Good will. Good will has been defined as "the probability that the old customers will resort to the old place." It is a partnership asset, but not part of a firm's "stock in trade." Thus, if the "assets" of a firm are purchased, they include good will; but if only the "stock in trade" is purchased, good will is not included.

660. Capital. Partnership capital is the aggregate of the sums, either in money or agreed value of property, contributed by the partners for the transaction of the partnership business. General partners may contribute cash, property or services as

¹⁰ *Charles S. Higgins Company v. Higgins Soap Company*, 144 N.Y. 463.

¹¹ In New York, for example (Laws of 1945, Ch. 842), partners may now sue or be sued in the firm name. A summons may be served on any one or more of the partners for the entire firm, with the same effect as if all partners had been specifically named.

capital. Special or limited partners may contribute only cash or property as capital.

Partnership capital v. partnership property. Partnership capital differs from partnership property in at least three respects:

(1) As to amount: Partnership capital is fixed in amount and cannot be changed except by consent of the firm. Partnership property may vary in amount from time to time, and may be more or less than partnership capital.

(2) As to undivided profits: Partnership capital does not necessarily include undivided profits, although the partnership agreement may provide that undivided profits will, at the option of the partners, become part of the capital. Partnership assets necessarily include undivided profits.

(3) As to distribution upon dissolution: Capital is regarded as an obligation to the partners, repayable, upon dissolution, in proportion to the amounts contributed, before net assets are figured and distributed. Net assets, *in the absence of agreement to the contrary*, are distributed to the firm equally upon dissolution, like profits, and regardless of unequal contributions of capital.

Capital v. loans or advances. When a partner lends or advances money to his firm, such loan or advance is not regarded as capital, but as an obligation to be repaid ahead of capital (sec. 706). Loans or advances generally bear interest, capital contributions do not. (See sec. 673.) However, by long standing rule, adopted by the Uniform Partnership Act, a partner (unless otherwise agreed) receives interest on the capital contributed by him from the date when repayment should be made.

661. Partnership property. Partnership property includes: All property originally contributed by the partners to make up the capital of the firm; all property subsequently acquired by the firm, either with firm funds, or by services and transactions on behalf of the firm; and undivided profits. Partnership property also includes any property, profits or proceeds, directly or indirectly acquired through the use of firm property, firm time or firm knowledge, which in good conscience should go to the firm.

662. Rights of partners in firm property generally. The property rights of a partner are his rights in specific partnership property, his interest in the partnership, and his right to participate in the management.

663. Partner's right in specific partnership property. A partner is co-owner with his partners of specific partnership property. He holds as a *tenant in partnership*, corresponding to a tenancy in common held by co-owners in a joint venture. However, a tenancy in partnership, unlike a tenancy in common, is subject to the claims of partnership creditors and can-

not be "partitioned" (in the case of real property), or distributed (in the case of personal property), between or among the partners, unless firm debts are first paid and firm claims satisfied.

Example: Two sons, Robert and William MacFarlane, having inherited a manufacturing establishment from their father, went into possession; conducted the business and, for two years, divided profits equally. Then Robert sued for partition of the real property owned by the business. William defended on the ground that the business was a copartnership, and hence that partition could not be had until firm affairs were wound up, creditors paid and partners' interests adjusted. William's position was well taken.

A partner's interest as a tenant in partnership gives him an equal right with his copartners to possess and use specific partnership property *for partnership purposes*. He has no right to possess such property for any other purpose without the consent of his copartners. Hence, a partner's right in specific property is not assignable without the consent of his copartners. Neither is it subject to attachment or execution (sec. 74), except on a claim against the firm. For the same reason, a partner's right in specific property is not subject to dower, curtesy or allowances to widows, heirs or next of kin.

On the death of a partner, his right in specific partnership property vests in the surviving partner or partners, except where the deceased is the last surviving partner, in which case his right in such property vests in his legal representative. Such surviving partner or partners, or the legal representative of the last surviving partner, has no right to possess the partnership property for any but partnership purposes.

664. Partner's interest in partnership. A partner's interest in the firm itself, as distinguished from specific property owned by the firm, is the partner's share of the profits and surplus; that is, it is an interest in everything that the firm owns and earns, subject to the claims of creditors. Such interest is personal property, though the firm as such owns nothing but real property.

Conveyance of partner's interest in firm: effect of. A conveyance by a partner of his interest in the firm does not of itself dissolve the firm. Nor does it entitle the assignee, during the continuance of the partnership, to interfere in the management of the partnership business. Such assignee or purchaser, including a purchaser at a sale under execution issued on a

judgment against a partner, acquires no partnership rights whatsoever, except to receive profits and surplus after firm creditors are satisfied.

Example: Clements acquired the interest of Shea in the firm of Shea & Schnorr by purchase at a sale under execution issued on a judgment against Shea individually. Subsequently Shea & Schnorr gave a chattel mortgage on firm property to Jessup, a firm creditor. Jessup's rights in the property, the court held,¹² were superior to Clements'. Clements acquired Shea's interest only. Such interest was subject to firm debts, including the debt to Jessup, a firm creditor. The chattel mortgage to Jessup was not invalid merely because it was executed after the sale of Shea's interest in the firm, unless the sale was fraudulent, or constituted an unlawful preference (sec. 1293).

F. Rights, Duties, Powers and Liabilities of Partners:

(2) As to One Another

665. **In general.** Rights and duties being *reciprocal* (sec. 18), the right of each partner as to the others represents a corresponding duty of the others to respect and conform to such right. Such rights and duties may be prescribed in the articles of copartnership, or they may be imposed by law in the absence of express agreement. If a partner violates any of the terms in the articles of copartnership, he must respond in damages to his copartners for consequent loss. If he violates any duty toward his copartners imposed by law, he is likewise liable for consequent loss or damage.

666. **Good faith.** As in agency, so in partnership—the relationship between partners is fiduciary (sec. 562). This is because of the mutual agency of partners (sec. 677). Hence, a partner must account to his copartners for any personal profit, advantage or secret commission earned out of his partnership connection. No partner may take unfair advantage of his copartners.¹³

Examples:

(1) In *Meinhard v. Salmon*,¹⁴ Salmon obtained a lease in his own name, but Meinhard contributed his share of the funds toward the venture and agreed to bear his share of any loss. Prior to the expiration of the lease, Salmon, without the knowledge of Meinhard, obtained a new lease to the premises and, in addition, several adjoining parcels, in the name of a corporation owned by Salmon. *Held*, that Meinhard, who was thus excluded,

¹² *Clements v. Jessup*, 36 N.J. Eq. 569.

¹³ *Stephens v. Stephens*, 298 Ky. 638, 183 S.W. 2d 822.

¹⁴ 249 N.Y. 458.

was entitled to impress a trust to the extent of one half the stock of the corporation.

(2) *A, B and C* entered into a partnership for the sale of a large plant on commission. After several years of effort, chiefly by *A*, the owners wrote that they had decided not to sell, whereupon *B* and *C* wrote *A* that they deemed their partnership at an end. *A* wrote back urging a further conference, but *B* and *C* did not reply. Five months later, *B* and *C* renewed negotiations to sell the plant and ultimately closed the deal and collected a \$60,000 commission. In a suit by *A* against *B* and *C* for his share of the commissions, a court would find that the facts spelled out a breach of good faith, or, at least, that *B* and *C*, having profited from partnership information, must account to *A* for his share of the profits.

(3) See sec. 1608.

Right to offset losses and expenses against secret profits. When a partner who has made a secret profit is brought to account, he should not, on principle, be allowed to offset against such profit any expenses incurred in making the profit or losses on other secret transactions; yet, although this is the rule in some jurisdictions, others, such as New York, permit the offending partner, in accounting to his copartners, to deduct such losses and expenses.

667. Loyalty to firm interests. A partner's loyalty to his firm corresponds to the loyalty required of an agent toward his principal (sec. 562). He must not serve interests which conflict with those of the firm, have a personal interest adverse to the firm's, or engage in a competing business.

668. Care and skill. A partner, in the discharge of his duties, must exercise that degree of care, skill, diligence and economy that the circumstances require. Anything less than this, resulting in loss to the firm, will render the partner liable for such loss.

669. Accounts and their inspection. Partners must keep true and accurate accounts of partnership transactions, and these must at all reasonable times be open to the inspection of all other partners at the place of business.

670. Right to share in management, knowledge and control of the business. No partner may control or monopolize the management of the partnership business to the exclusion of others. But partners may provide in the articles of copartnership for differing degrees of responsibility and authority. Otherwise, each partner has an equal voice with the others in the management of the business, and a majority governs. (For acts requiring unanimous consent, see sec. 684.)

Example: Smith, Howe and Rogers are partners engaged in the dry-goods business. Smith and Rogers wish to add a grocery department,

Howe objects. Unless otherwise agreed in the articles of copartnership, the wishes of Smith and Rogers prevail.

671. Profits and losses. In the absence of agreement to the contrary, partners share profits and losses equally, regardless of unequal capital contributions.

Example: Jones, Johnson and Perry form a partnership. Jones contributes \$5000, Johnson \$3000 and Perry \$1000. The articles of copartnership are silent on the division of profits. Jones, Johnson and Perry will share profits equally.

Definition of profits. The word "profits" is an elastic term.¹⁵ Profits may be arrived at in various ways, depending upon the items to be deducted from income in figuring profits. For this reason it is important, in drawing up articles of copartnership, to agree upon a definition of profits.

Interest on profits left in business. Unless so agreed, partners who leave profits in the firm are not entitled to interest thereon.

Sharing losses in proportion to profits. Where profit distribution is unequal, losses are shared in the same proportion, unless the partners have otherwise agreed.

672. Right to compensation. A partner is not entitled to extra compensation for extra services rendered by him for the firm unless the partnership agreement so provides. This does not apply to a surviving partner (sec. 700, "*Compensation*").

Example: A and B are partners in the hardware business. If A, because of B's illness, is required for several months to assume an extra burden in conducting the partnership business, he will not on that account be entitled to extra compensation.

673. Right to return of advances with interest. A partner, as already noted (sec. 660), is entitled to the return of loans or advances ahead of the firm's obligation to return capital investments, and he is entitled to interest on such loans or advances.

674. Right to return of capital. Upon dissolution, a partner is entitled to the return of his capital investment, after outside debts and advances by partners have been taken care of.

675. Right to have partnership property applied to partnership debts. The assets of a firm are not only a trust fund for the benefit of creditors; they also furnish a "buffer" to protect a partner's individual assets from the claims of creditors. (See sec. 708.)

¹⁵ There are literally hundreds of judicial definitions of the term *profit* or *profits*.

676. Right to contribution from copartners. The Uniform Partnership Act provides that the partnership must indemnify every partner for payments made and personal liabilities incurred by him on behalf of the firm in the ordinary and proper conduct of its business or in the preservation of its interests.

G. Rights, Duties, Powers and Liabilities of Partners:

(3) As to Third Parties

677. Mutual agency of partners. Each partner is a general agent for every other partner and for the firm, while acting within the scope of the partnership. Hence the firm and its partners are bound by the acts of any partner on behalf of the firm, not only when such acts are actually authorized, but also if they are not authorized but are within the *apparent* scope of the firm business. (See sec. 567.)

Agreements among partners not binding upon third parties. Agreements among the partners themselves, fixing their duties and liabilities and limiting their powers, are not binding upon third parties unless they have knowledge of such agreements or have acquiesced in them.

Example: The articles of copartnership of the firm of *A & B* provide that no written agreement shall be binding upon the firm unless it is signed by both partners. Such a provision is ineffective as to third parties unless they have knowledge of or have acquiesced in it.

678. Power to hire agents, servants and employees. When a partner hires third parties on behalf of the firm, either as agents, servants or employees, the latter are entitled to assume that the partner is authorized to hire them, regardless of whether he is actually so authorized or not. Hence, they may hold the firm for the compensation promised. But if a partner, in making such contracts of hiring, exceeded his powers, his copartners may hold him liable to the extent of any damage thereby sustained.

679. Power to convey real property. Where real property stands in the firm name, a conveyance by one of the partners in the firm name, unless it was actually or apparently authorized, may be rescinded by the firm and the property recovered, provided it has not passed from the purchaser to an innocent third party.¹⁶

Example: The Acme Coal Company, a partnership consisting of *A, B* and *C*, owns a coal shed and the land on which it stands. *A*, for a valua-

¹⁶ Uniform Partnership Act, sec. 10.

ble consideration, signs the firm's name to a conveyance of the property to the Bates Coal Company. If A is actually authorized to do this or if such conveyances so executed are customary with such concerns, the conveyance stands; otherwise, the Acme Coal Company can recover the property unless the Bates Coal Company has reconveyed it to an innocent third party.

Where title to the property is in the names of all the partners themselves, a conveyance executed by all the partners passes all their rights in such property.

Power to mortgage real property. "A partner cannot make a valid mortgage or deed of trust of his copartners' interests in firm real estate without their assent or ratification, or circumstances estopping them to dispute it, even though the mortgage be made in the partnership name and to secure a partnership debt, but in jurisdictions where equity treats firm realty as personal property,¹⁷ equity will sustain a mortgage upon firm realty given by one partner to secure a past or future firm indebtedness."¹⁸

680. Power to buy on credit. Regardless of whether or not a partner is actually authorized to make purchases for the firm on credit or whether his authority to make such purchases is limited to a given amount, third parties have a right to assume such authority within the customary limits fixed by usage in similar lines of business. This applies, however, to *trading* rather than *nontrading* firms (sec. 639). A partner in a nontrading firm has no implied power to bind the firm by purchases on credit.

681. Borrowing money. In most trading partnerships, it is customary to borrow money for the conduct of the business. Hence, whether a partner be actually authorized to do so or not, he may bind his firm by borrowing money on its behalf, and for this purpose he may make, indorse, draw and accept firm paper in the firm name. Such transactions being customary, third parties are entitled to assume that a trading partner has such authority. However, third parties have no right to assume such authority in the case of a nontrading partnership, because it is not customary.

Borrowing money on individual paper. If a partner borrows money against a note, draft or other instrument that shows on its face that it is not firm paper, the firm is not bound, even if the partner signs or indorses the firm name. Even if the money is used for firm purposes, only the borrowing partner (if the firm is nontrading) is liable to the payee, though

¹⁷ Citing Alabama, Colorado and Texas cases.

¹⁸ 47 *Corpus Juris Secundum* 857.

such partner may compel his copartners to make good their share of the proceeds of the loan. (For an example, see sec. 1609.)

682. Accommodation paper and contracts of guaranty and suretyship. As already pointed out (sec. 329), a partner has no right to execute or indorse accommodation paper in the name of the firm. Third parties are supposed to know this. Neither has a partner implied authority to bind his firm by a guaranty or suretyship. However, if the partner has been expressly authorized by his firm to do any of these acts or if they are in furtherance of the partnership business, the firm will be bound.

683. Partnership gifts. Partners may unanimously agree to give away what they wish to, as long as firm creditors are not thereby prejudiced ("one must be just before he is generous"), but no partner, alone, has the *implied* power to make a gift of partnership property. Such gift may, however, be binding so far as concerns the partner's own interest in the property.¹⁹

684. Acts requiring unanimous consent. The Uniform Partnership Act provides that, unless authorized by the other partners or unless the partners have abandoned the business, one or more but less than all the partners have no authority to:

(a) Assign the partnership property in trust for creditors or on the assignee's promise to pay firm debts.

(b) Dispose of the good will of the business.

(c) Do any other act which would make it impossible to carry on the ordinary business of the firm.

(d) "Confess a judgment" (that is, sign and swear to a paper which permits a creditor to enter up a judgment against the firm without a law suit).

(e) Submit a partnership claim or liability to arbitration or reference (sec. 251).

685. Noncontract liabilities of partners: torts and crimes. Not only are general partners, as distinguished from special or limited partners, liable for debts and other contract obligations that any member may incur within the actual or apparent scope of his authority, but they are likewise liable for torts committed during the course of the partnership.

Example: *H*, of the warehousing firm of *G & H*, issues without *G*'s knowledge, a false warehouse receipt to Nash & Son, who borrow \$4000 on it from Robbins. On discovering the facts, Robbins may hold *G* as well as *H*, since *H* committed the fraud while acting as a partner.

¹⁹ 47 *Corpus Juris* 856-7.

Partners are not liable for one another's criminal acts unless they participate in, approve, connive at, acquiesce in, or aid and abet the offense. Thus, in the example above given, *G* would not be liable criminally (sec. 485, subd. (d)) for the issuance of the false warehouse receipt.

686. Liability of deceased partner. A deceased partner's individual property is subject to levy for all obligations of the firm incurred while he was a partner, but only after firm assets are first applied toward payment of firm debts and after the estate of the deceased partner has paid off all his personal debts (see sec. 708).

687. How partners are liable: joint and several liability. The distinction between *joint* and *joint and several* liability has already been pointed out in sec. 175. The Uniform Partnership Act provides that all partners are liable jointly for all debts and obligations of the partnership, with the exception of liabilities arising out of tort or a breach of trust. As to these, partners are liable jointly and severally. However, the joint liability of partners for firm contracts has been construed to mean that the creditors may look primarily to the joint property of the firm for satisfaction of their claims, but, if that is insufficient, any of the partners is liable severally to pay the whole debt out of his individual property.²⁰ And the joint and several liability of partners in tort evidently means that the injured party may, at his option, sue all partners or any one, but if judgment is procured against the offending partner alone, he may not look to the others for contribution.

Example: *K* and *B* were partners. *K*, while driving a firm automobile on firm business, negligently injured *W*, who sued *K* and *B* individually but failed to serve *B* with a summons. Hence, judgment (for \$450) was entered against *K* alone. Subsequently, the firm was dissolved. *K* acquired the firm assets. Having been compelled to pay *W* the \$450, *K* sued *B* to recover one-half of the sum paid. The Court held that although both partners were jointly and severally liable for the tort, this meant that the plaintiff could have procured judgment against both partners or either of them. However, the judgment having been procured against *K* only, he only was liable for the tort; that is, the Court refused to apportion the wrong.²¹

A partner may enter into a separate obligation (as by contract of guaranty) to perform a partnership contract, in which case he will be separately, or *severally*, liable.

²⁰ *Matter of Peck*, 206 N.Y. 55.

²¹ *Kiffer v. Bienstock*, 128 Misc. 451, 218 N.Y.S. 526.

688. Liability of incoming partner. A person admitted into a firm is liable for all existing firm obligations, but this liability can be satisfied only out of partnership property.²² In other words, the liability of an incoming partner for pre-existing firm debts is not personal but is limited to his interest in the firm's assets. (See sec. 1595, subd. b.)

Example: C is admitted to the firm of A and B on contributing \$5000 as capital. Prior to C's admission the firm had incurred a \$50,000 obligation, which the firm assets are now insufficient to cover. C's liability in such case is not personal. He stands to lose no more than his interest in the firm's assets.

689. Liability of retiring partner. A retiring partner's liability for debts of the firm depends upon whether such debts were incurred before or after retirement.

Debts incurred before retirement. A retiring partner is liable for all existing obligations of the firm. Although partners may agree among one another that the retiring partner is to be freed of existing firm debts, such agreement is not binding upon creditors unless they acquiesce.

Example: One of three members retires from a firm, the remaining members assuming all responsibility for the then outstanding debts. Before these debts are paid, the new firm becomes insolvent. As to such debts, the retiring partner remains liable.

Debts incurred after retirement. A retiring partner is not liable for firm debts incurred after his retirement, provided he has given proper notice of his retirement. Such notice must be *actual* as to all parties who have previously extended credit to the firm and who have no other knowledge of his retirement, and *constructive* (notice by advertisement) as to all others. (See sec. 1611.) Under the common law, creditors were entitled to actual notice of retirement even if they had not previously extended credit to the firm, as long as they had previously "dealt with" the firm, but under the Uniform Partnership Act, actual notice is required only as to creditors who have "extended credit to the partnership prior to dissolution and had no knowledge or notice of the dissolution."

Retirement of secret partner. When a *secret* partner retires, he need not notify creditors. Since they did not know of the secret partner's connection with the firm, they are not hurt by not being informed that such connection has ceased to exist.

H. Dissolution of Partnership

690. Meaning of dissolution. The Uniform Partnership Act defines the dissolution of a partnership as "the change in the relation of the partners caused by any partner ceasing to be associated in the carrying on as distinguished from the winding up of the business."

²² Uniform Partnership Act, sec. 17.

Partnership not terminated by dissolution. On dissolution, the partnership is not terminated but continues until partnership affairs are wound up.

Dissolution v. rescission. If a partner is induced by fraud or misrepresentation to enter into a contract of partnership, he may, upon discovering the fraud, sue for rescission of the contract. The effect of rescission is to dissolve the firm. However, rescission differs from dissolution in the following respects:

(a) Only fraud or misrepresentation will furnish ground for rescission, whereas dissolution may arise from a variety of additional causes (secs. 692-696).

(b) Upon rescission, a partner is entitled, as far as possible, to be restored to the position he was in before he entered the firm, at least so far as concerns his copartners; this is not true of dissolution.

(c) Upon rescission, a partner's remedies are broader and his liabilities narrower than upon dissolution, because in the former case he may compel his fraudulent copartners to make good his share of liability to creditors, and such liability in any event is limited to the period between entering and rescinding the partnership.

The Uniform Partnership Act provides²³ that where a partnership contract is rescinded on account of fraud or misrepresentation, the party entitled to rescind has the following remedies, in addition to any other rights:

(a) A lien, or right to retain any firm surplus after payment of firm debts, as security for any money paid into the firm by the defrauded party, either as capital or by way of advances.

(b) A right, after third party liabilities are satisfied, to stand in the place of firm creditors for any payments by the defrauded party on account of firm debts.

(c) A right to be indemnified by the fraudulent party against all firm debts and liabilities.

Example: Atwood and Chapin, copartners, are insolvent. Atwood, fraudulently representing the firm to be solvent, induces Morton to become a partner and to make a capital investment of \$10,000. Upon discovery of the fraud, Morton may (a) rescind the contract; (b) reject any claim asserted by any person who became a creditor before Morton became a partner²⁴; (c) retain firm assets (subject to debts incurred after Morton joined the firm) by way of lien or security for repayment of his capital; (d) stand in the place of firm creditors for any payments made by Morton on account of firm debts; and (e) require indemnification by Atwood against all firm debts and liabilities.

691. Voluntary v. involuntary dissolution. A partnership is voluntarily dissolved when its dissolution is brought about by agreement of the partners; otherwise, the dissolution is involuntary. Voluntary dissolution may be brought about by

²³ Section 39.

²⁴ Although under the Uniform Partnership Act an incoming partner is liable for all existing firm debts out of existing firm assets, this could scarcely be construed to include assets of an incoming partner fraudulently brought into the firm *after* the debt was incurred and the credit extended.

the terms of the *original* agreement—as by provision for a time limit, completion of the purpose set forth in the partnership agreement, or an event, condition or contingency on the happening of which the partnership is to terminate—and by *subsequent* agreement.

Where no time is specified for its duration, a partnership may be terminated at the will of any member.

692. Involuntary dissolution: how brought about. Involuntary dissolution of a partnership may be brought about automatically by operation of law, as in the case of death, bankruptcy or illegality, or it may be judicially decreed at the instance of a partner or someone standing in his place.

693. Dissolution upon death of partner. Death dissolves the partnership unless the partnership agreement specifically provides to the contrary. Upon the death of a partner, his personal representative (sec. 1177) stands in his place. The voluntary character of a partnership forbids a rule that would compel persons to accept a new partner against their will. The executor or administrator of a deceased partner's estate has merely the right to require that the surviving partner or partners wind up the affairs of the firm within a reasonable time and pay over to the estate the deceased partner's share of firm assets and profits after payment of firm debts.

694. Dissolution through bankruptcy. Unless the partnership agreement provides to the contrary, the bankruptcy of a partner automatically dissolves the firm. Since upon the bankruptcy of a partner a trustee stands in his place, the rule of dissolution is similar to that in the case of a partner's death.

695. Dissolution because of illegality. "A partnership is dissolved when the further prosecution of the enterprise has become illegal, or when one of the partners becomes so situated that it is illegal for him to continue in the partnership business." ²⁵

Example: If one of the members of a law firm is elected a judge, so that it becomes illegal for him to practice law, the firm is thereby dissolved.

696. Dissolution by judicial decree. Ordinarily, only a partner is entitled to apply for a judicial decree of dissolution. As noted in sec. 664, the purchaser or assignee of a partner's interest in a firm, including a purchaser at an execution sale on a

²⁵ 47 *Corpus Juris* 1115.

judgment against a partner, acquires no partnership rights whatsoever, except to receive profits and surplus after firm creditors are satisfied. He may, however, apply for a decree of dissolution when the partnership is one at will, or for a specified term which has elapsed, or for a particular undertaking which has been completed.

On application by or on behalf of a partner, the Court must decree a dissolution in any of the following cases:

(1) *Insanity*: Where a partner has been adjudged a lunatic, or is shown to be of unsound mind.

(2) *Incapacity*: Which must be relatively permanent, not temporary, showing that the partner lacks the necessary health, strength, diligence or skill required to conduct his duties as partner.

(3) *Misconduct*: Which must tend "to affect prejudicially the carrying on of the business;"²⁶ for a court will not "enter into a consideration of mere partnership squabbles."²⁷

Examples:

- (1) Persistent violations of the articles of copartnership.
- (2) Abandonment of the business by a partner.
- (3) Excluding a copartner from participation.
- (4) Repudiating a copartner's lawful interest.
- (5) Dishonesty.
- (6) Habitual drunkenness.
- (7) Acts leading to a state of "irreconcilable discord."

Example: If X, Y and Z form a three-year partnership, and Z, during the first year, disagrees continuously with X and Y to the point of "irreconcilable discord," dissolution by judicial decree would be in order.

(4) *Futility*. If a partnership is being carried on at a heavy loss, or if it becomes evident that further prosecution of a partnership must inevitably lead to loss or failure or that its purpose is unattainable, a dissolution may be decreed to avoid carrying on a useless project or incurring certain loss.

(5) *Other circumstances*: Which make it equitable to decree a dissolution.

697. Power v. right of partner to withdraw. A partner cannot be compelled to remain in a firm longer than he desires to do so, even though, in withdrawing, he violates his contract; but in the latter case, he is liable to the firm for consequent loss. A partner at will may retire when he pleases. Hence, in a partnership organized without mention of duration, any partner may retire at any time and receive the value of his interest in the firm.

²⁶ Uniform Partnership Act, sec. 32 (1) (c).

²⁷ *Cash v. Earnshaw*, 66 Ill. 402.

698. Notice of retirement. We have already pointed out the notice that a retiring partner must give to third parties if he desires to avoid liability for future obligations of the firm (sec. 689). As to his copartners, a retiring partner must give such notice as the articles of copartnership require. In the absence of such provision, he should give reasonable notice. Such notice need not be written. Even a partner at will must give such notice as may be required in the *articles*, or reasonable notice in the absence of specific provision.

699. Expulsion of partner. Unless such right is specified in the *articles*, partners may not expel one of their members, even though all but the objectionable member agree upon such expulsion. However, partners have the *power* to accomplish the same result by dissolving the firm and forming a new one that excludes the undesirable partner. If this is done contrary to agreement and without justification, the partner excluded may hold the others liable in damages.

700. Effect of dissolution: surviving and liquidating partners. Immediately upon dissolution, all authority of the partners ceases insofar as *new business* is concerned. For the purpose of winding up the affairs of the firm, however, partners continue in authority, not as partners, but as trustees in respect to firm assets, the discharge of firm debts, and a proper distribution of assets remaining after payment of such debts. If a surviving or liquidating partner continues the partnership or conducts new business not necessary or incidental to winding up the affairs of the firm, he only, and not firm assets, will be charged thereby, except as to persons without knowledge or notice of the dissolution. (For an example, see sec. 1615.)

A surviving partner, in winding up the affairs of the firm, is chargeable as a trustee in respect to firm assets. He may not appropriate the good will for himself but must account for it as a firm asset. (See sec. 1616.)

Receivership. Where liquidating partners are at odds in the process of winding up, the Court may appoint a receiver, provided the dispute is real and the petitioner not a mere troublemaker.

Compensation. Liquidating partners may be allowed compensation for liquidating services, but not if their conduct is repugnant to equity.

Example: *J & G*, as partners, conducted business as *J's Delicatessen Market*. *G* died. *J*, denying the existence of the partnership, refused to account to *G's* executor. The executor sued for an accounting, whereupon

J sought compensation for services as surviving partner. The court, in view of *J*'s conduct, rejected his claim.²⁸

701. Partnership remedies. The remedies of a firm against outsiders are the same as those of ordinary persons against one another. However, the remedy of partners *as to one another* can be obtained only in equity, because the relationship between partners is fiduciary. If a partner sues his firm or the firm sues a member, we have an instance where an individual is suing himself, or being sued by himself, to the extent that the firm includes himself; and if a partner who thus sues should recover a judgment, he might be called upon as a partner to help satisfy his own judgment. Thus, simple actions at law between a firm and its members are usually inadequate to determine the balance of remedies among them. For this reason, partnership remedies must be sought by way of an accounting in equity rather than by way of damages at law. However, suits between partners which in no way involve the partnership may be brought in an ordinary law court.

Example: If Martin and McBride are partners, and Martin personally furnishes supplies to McBride in connection with a separate business in no way involving the partnership, Martin may sue McBride at law for any unpaid balance.

Suits between joint adventurers (sec. 636) may ordinarily be brought at law, especially where profits are ascertained or the suit is for breach of contract in refusing to recognize a joint-adventurer's interest.²⁹ But where suit is brought for damages for alleged preventable losses sustained in a joint adventure, involving many items of disputed debit and credit, there can be no recovery until the transaction has been closed and a balance struck; hence, the remedy would lie in equity.

The usual partnership remedies include: (a) accounting and dissolution, (b) injunction and (c) receivership.

702. Accounting and dissolution. A partner's interests and rights in the firm may be ascertained and made available by an accounting. A demand for an accounting is usually, but not necessarily, joined to a demand for dissolution. A partner may have an accounting without dissolution where he is wrongfully excluded, where the right exists by agreement, where secret profits or property have been acquired with the aid of partnership funds or property, and whenever other circumstances render it just and reasonable. However, one can-

²⁸ *Germann v. Jones*, 220 App. Div. 5, 221 N.Y. Supp. 32.

²⁹ 33 *Corpus Juris* 866-867.

not have a dissolution without an accounting, because dissolution is followed by distribution, which cannot be had without an accounting.

703. Injunction. In unusual cases, a partner may demand an injunction, as, for example, where, upon demand for an accounting and dissolution, there is danger that a copartner may monopolize the management of the firm, control or "doctor" its books, papers, records and credits, do away with assets, or otherwise render an accounting ineffectual without an injunction.

704. Receivership. As already pointed out (sec. 700), the Court may appoint a receiver where circumstances require. A receiver is an officer of the Court. He must give bond, must conserve the assets and wind up the affairs of the firm satisfactorily and expeditiously and must render an accounting upon the discharge of his duties.

705. Order of distribution of firm assets. In the voluntary dissolution of an *ordinary* partnership, assets are distributed in the following order:

- (1) To creditors other than partners.
- (2) To partners for liabilities other than for capital and profits.
- (3) To partners for liabilities in respect to capital.
- (4) To partners for liabilities in respect to profits.

In the case of a *limited* partnership, a different order of distribution is adopted. (See sec. 720.)

706. Adjustment of liabilities as among partners. The adjustment of liabilities as among the partners may be fixed by agreement, but, if not, it is governed by the following rules:³⁰

(a) Each partner must be repaid his contributions, whether by way of capital, or advances to the partnership property; and

(b) Each partner is entitled to share *equally* in the profit and surplus remaining after all liabilities, *including those to partners*, are satisfied; and

(c) Each partner must contribute toward the losses, whether of capital or otherwise, sustained by the partnership, *according to his share in the profits*.³¹

Example: Suppose *A*, *B* and *C* are partners. *A* contributes \$10,000 to the capital, *B* \$5,000, and *C* his skill. The partnership is terminated by the expiration of the time specified in the articles of copartnership. After all debts and liabilities to third parties are paid, \$3,000 remains. There

³⁰ Uniform Partnership Act, sec. 18 (a).

³¹ *Whitcomb v. Converse*, 119 Mass. 38.

have been no capital withdrawals. The question would thus arise as to how the \$3,000 should be divided:

(1) In the absence of agreement to the contrary, *A*, *B* and *C*, sharing equally in the profits, must share equally in the losses. The combined loss being \$12,000 (\$15,000 capital contributed, less \$3,000 remaining), *A*, *B* and *C* are each liable for \$4,000, or one third of such loss. *A* is credited with \$10,000 originally contributed, less \$4,000, or \$6,000. *B* is credited with \$5,000 originally contributed, less \$4,000, or \$1,000. *C* is credited with nothing contributed, less \$4,000, or a net charge of \$4,000 owing to the firm. The tabulation would be as follows:

<i>Partner</i>	<i>Capital</i>	<i>Sh. of Loss</i>	<i>Net to Partner</i>
A	\$10,000	\$4,000	\$6,000
B	5,000	4,000	1,000
C	0	4,000	-4,000
Total	\$15,000	\$12,000	\$3,000

(2) Assuming that *C* is insolvent, we must treat *C*'s debt as a loss to be borne equally between *A* and *B*, so that the total loss to *A* and *B* each (\$4,000 plus \$2,000) is \$6,000. Deducting \$6,000 from the \$10,000 originally contributed by *A*, gives him \$4,000; and charging \$6,000 against the \$5,000 originally contributed by *B*, leaves a net debt owing by *B* in the sum of \$1,000, which goes toward discharging the firm obligation to repay *A* \$4,000, the balance due him on capital. In other words, the remaining \$3,000 asset of the partnership, plus \$1,000 due from *B*, goes to *A*. The tabulation would be as follows:

<i>Partner</i>	<i>Capital</i>	<i>Sh. of Loss</i>	<i>Net to Partner</i>
A	\$10,000	\$ 6,000	\$4,000
B	5,000	6,000	-1,000
Total	\$15,000	\$12,000	\$3,000

Adjustment of losses: profit ratio fixed by agreement. Where the profit ratio is fixed by agreement, adjustment of losses must follow the profit ratio.

Example: Brown, Coates and Danforth, partners, share profits by agreement in the ratio of one-fourth, one-third and five-twelfths, respectively. On dissolution, firm liabilities exceed firm assets by \$24,000. Coates, without contributing to the loss, moves to Europe, beyond legal process. Brown and Danforth must share the \$24,000 loss in the ratio of one-fourth to five-twelfths, or \$9,000 to \$15,000, respectively.

Adjustment of losses: liability for interest. As previously noted (secs. 660 and 673), loans and advances bear interest but capital contributions, unless so agreed, do not, until they become fixed obligations upon accounting and dissolution. From then on, all partners must contribute equally, in the absence of contrary agreement, not only to the principal of balances due to outside creditors and to partners for capital and advances, but also to accrued interest on such balances. This liability applies as much to a

partner who contributes only skill and services as to any other partner.³²

Adjustment of losses: insolvency v. bankruptcy of copartners. Where a solvent partner, because of the insolvency of his copartners, is compelled to discharge the entire burden of firm debts, his right to contribution is unaffected by the fact of their insolvency, unless the insolvent partners are adjudicated and discharged in bankruptcy (secs. 1281 and 1343). For an illustration, see sec. 1621.

Priority of advances in distribution of assets. Where one of the partners makes an advance beyond his capital contribution, the advance, on liquidation and final settlement, is repayable ahead of capital contributions. For an example, see sec. 1619.

707. Personal liability of partners for firm debts. Partners are personally liable for the debts of the firm, *provided firm assets are insufficient to satisfy such debts*. Such liability, as previously noted (sec. 686), survives the death of a partner, so that his estate is correspondingly liable.

708. Marshaling assets. The term *marshaling assets*, as pointed out in sec. 10, means making them available in a given order of priority in connection with various classes of claims. It is an equitable doctrine. As applied to partnership, it means that upon application in a proper case, a court of equity may require that firm assets must first be made available for payment of firm debts, and the partners' individual assets for the payment of their respective individual debts. If, after payment of firm debts, a surplus remains, such surplus, in which each individual partner has an undivided interest, may be applied to the payment of the partners' individual debts. If, after a partner pays his personal debts out of his personal assets, a surplus remains, such surplus may be applied to the payment of firm debts, *provided firm assets are insufficient for this purpose*.

Examples:

(1) Jones, Smith and Brown are equal partners. On dissolution, the firm has assets of \$50,000 and liabilities of \$35,000. The partners thus have a net equity in the firm of \$5,000 each. They have no other personal assets, but they owe personal debts of \$5,000 each. Under the rule of marshaling assets, the personal creditors of Jones, Smith and Brown cannot resort to the firm assets until the firm creditors (with \$35,000 in claims) are first satisfied; that is, each of the partners' personal creditors may resort to each partner's \$5,000 equity in the firm for satisfaction of their personal claims.

³² *Whitcomb v. Converse*, 119 Mass. 38; *Rhein v. Pessio*, 194 App. Div. 274, 185 N.Y. Supp. 150.

(2) Suppose that, in Example (1), firm assets were \$50,000 and firm liabilities \$65,000; that Jones and Smith were insolvent; but that Brown, with personal assets of \$15,000, owed personal debts in the same amount. Firm creditors would have no right to resort to Brown's personal assets, because Brown's personal creditors come first.

(3) *A* and *B* are partners. *A* dies. Assets in liquidation amount to 75% of liabilities. *A*'s estate is solvent. *B* is insolvent. By the rule of marshaling assets, firm creditors may have access to *A*'s assets only after firm assets are exhausted (in this case, to the extent of 25% of their claims), but not until the individual creditors of *A*'s estate have first been paid. Since *B*'s personal creditors may resort to firm assets only after payment of firm debts and since firm assets are insufficient to pay firm debts, *B*'s creditors would receive nothing.

(4) The firm of Baxter, Brady & Childs makes a promissory note to Voorhis. Childs dies before the note is due. On due date, the note is unpaid. If Voorhis sued Baxter, Brady and Childs' executor, the suit against the executor would have to be dismissed. Upon the death of a partner, the firm is dissolved and its assets are administered by the surviving partners as trustees (sec. 693). Firm creditors must first look to firm assets for payment. Only after firm assets prove insufficient to pay firm debts may firm creditors look to the individual assets of existing or deceased firm members, and even then only after personal debts have been paid.

(5) See also sec. 1597, subd. *b*.

What constitutes firm creditor. A person is not a firm creditor unless value was given by him to, on the credit of, or for the benefit of the firm. Hence, a person giving value to, on the credit of, or for the benefit of a partner or partners, as distinguished from the firm itself, is not a firm creditor. (See sec. 1622.)

709. Bankruptcy and partnership. Where a partnership is declared bankrupt, the separate assets of all partners, as well as of the partnership estate are drawn into bankruptcy, regardless of whether or not the individual members as such are adjudicated bankrupts; that is, the partners are subjected to the payment of partnership debts, regardless of whether all or any of them are declared bankrupt individually. Such individual liability, however, is subject to the prior claims of individual creditors (sec. 708). See also secs. 1338 and 1623. However, the bankruptcy of an individual partner does not draw the partnership property into his bankrupt estate, except with the consent of the remaining partners or unless the bankrupt is the sole surviving member of the firm and has control of the partnership assets.³³

³³ 8 *Corpus Juris Secundum* 428-429.

I. Limited or Special Partnership

710. Definitions. A *limited* or *special* partnership is one formed pursuant to special statute³⁴ permitting certain partners to be silent or inactive and to limit their liability to the respective amounts of their investments. Thus, an agreement to share profits ratably, but losses only as to some partners, constitutes a limited partnership.

A *limited* or *special* partner is one who does not participate to the full in partnership liability. He is permitted to limit his liability to the amount of his investment, provided such limitation is duly specified in the limited partnership certificate.

Uniform Limited Partnership Act. A Uniform Limited Partnership Act has been adopted by the states shown in the table on pages 12-13.

711. Limited partnership certificate. Persons desiring to form a limited partnership must sign and swear to a certificate designating the names and residences of the partners, their capital contributions, which partners are general and which special, the specified limitations of special partners, and other pertinent information. This certificate must be filed, recorded and published. The object of these provisions is to insure that any member of the public, including prospective creditors, may be fully informed as to the limitations in liability on the part of the partners composing the firm, so that existing and prospective creditors may be properly protected.

Limited partnership must include general partner. A limited partnership, which includes one or more special partners, may also include one or more general partners, but it must include at least one general partner.

712. Limited partner's contribution. The contribution of a limited partner must be either in cash or other property. It *cannot consist of services*.

713. Limitation on firm name. A limited partnership must not contain the surname of a limited partner, unless it is also the surname of a general partner or unless the business has been previously carried on under a name that included such surname.

714. Right to profits. A limited partner has the right to receive profits and compensation stipulated in the certificate, either out of partnership property or out of the property of a

³⁴ Limited partnerships were unknown at common law.

general partner, provided the rights of outside creditors are not thereby impaired.

715. Right to inspection of books and formal account. A limited partner has the same right as a general partner to have the partnership books available for inspection at the principal place of business, to demand and receive full information as to partnership affairs and to require a formal account when circumstances render it just and reasonable.

716. Right to return of capital contribution. A limited partner has the right to the return, in whole or in part, of his capital contribution to the firm, upon consent of all members and upon the cancellation or amendment of the partnership certificate, provided that such return does not jeopardize the claims of outside creditors.

Subject to the rights of creditors and to the terms of the partnership certificate, a limited partner may also rightfully demand the return of his contribution upon dissolution, on the date specified in the certificate for its return, or upon giving six months' notice in writing to all other members, if no time is specified in the certificate, either for the return of his contribution or for the dissolution of the partnership.

717. Right to dissolution. A limited partner may have the firm dissolved and its affairs wound up when:

(a) He rightfully but unsuccessfully demands the return of his contribution, or

(b) The other liabilities of the partnership have not been paid or the partnership property is insufficient for their payment, and the limited partner would otherwise be entitled to the return of his contribution.

718. Liability of limited partner. Limited partners, as such, are not personally bound by the obligations of the firm, but their capital contributions are subject to claims of firm creditors, and limited partners cannot claim a return of their capital contributions until the claims of such creditors are satisfied or safeguarded.

Example: If a special partner contributes \$50,000 as capital and then, either before or after dissolution, withdraws it while creditors' claims are unpaid, such creditors may have recourse to such fund for payment.³⁵

³⁵ Some authorities hold that the special partner in such case may be joined in the same suit with the general partners, but by the weight of authority, creditors must first exhaust their remedies against the general partners before seeking to hold the special partner.

Liability for misstatement in partnership certificate. A limited partner is liable for loss sustained by any person doing business with the firm, by reason of a misstatement in the certificate of partnership knowingly made or assented to by a limited partner.

719. When limited partner may become liable as a general partner. If (except as noted in sec. 713) a limited partner permits his surname to be used in the firm name, he becomes liable as a general partner. Also, a limited partner may become liable as a general partner if he takes an active part in the management of the business.

720. Order of distribution in limited partnerships. The Uniform Partnership Act provides that in settling accounts after dissolution, the liabilities of a limited partnership are discharged in the following order:

- (a) Those to outside creditors in the order of priority as provided by law.
- (b) Those to limited partners in respect to their share of the profits and other compensation by way of income on their contributions.
- (c) Those to limited partners in respect to their capital contributions.
- (d) Those to general partners other than for capital and profits (advances, loans, and so on).
- (e) Those to general partners in respect to profits.
- (f) Those to general partners in respect to capital. (For an example, see sec. 1625.)

Questions and Problems for Review

1. What is a partnership and what are its three important characteristics? Define (a) ostensible partner, (b) silent partner, (c) limited partner. *NY June 1932 (5)*

2. What is a partnership? How may such a relationship be established? Define (a) nominal partner, (b) silent partner, (c) special partner. *NY Jan. 1924 (7); NY June 1918 (15)*

3. State the essentials of a valid partnership as between the individuals thereof. Does an agreement providing that profits are to be shared ratably by all and losses to be borne by only some of the partners affect the validity of the partnership? Give the reason for your answer to the question. *NY Nov. 1934 (5)*

4. Watson and Titus were partners under a partnership agreement that made no mention of the death of either. Watson by his will bequeathed his interest in the partnership to his wife. Upon Watson's death, did his wife become a partner with Titus by virtue of this legacy in Watson's will? *AI Nov. 1934 (4)*

5. A, B and C are engaged as partners in the lumber business.

A dies and bequeaths his entire estate to his son, *X*. *X* desires to come into the firm in his father's place. What are *X*'s rights? *AI May 1923 (8)*

6. Can one partner transfer his interest to a stranger without consent of his copartners? *AI Nov. 1918 (Part 1)*

7. In an agreement for sharing profits entered into between two partners of a business concern and three employees, how should the agreement read to distinguish it from one of general partnership? *AI May 1919 (10)*

8. *A* and *B* are partners and employ *C* as a manager of their business. They agree to pay him 15% of the profits as a salary. Subsequently, *X* sells a bill of goods to the partnership and seeks to charge *C* as a partner. Can he succeed? *AI May 1920 (11)*

9. *A* decides to go into a retail business, and to enable him to do so *B* and *C* lend *A* the sum of \$10,000 for one year under an agreement in which *A* agrees to pay to *B* and *C* as interest on such loan 5% of the net profits of the business for one year. Subsequently the *X* Company, which has sold goods to *A*, brings suit against *A*, *B* and *C* as copartners, for the unpaid purchase price. Does *X* Corporation recover against *B* and *C*? *AI May 1927 (11)*

10. Bigelow engaged the services of Ely to manage a public garage owned by Bigelow. A written agreement was entered into under which Bigelow agreed to pay Ely a salary of \$45 a week and 15% of the net profits of the business. Did the agreement constitute Bigelow and Ely as partners? *AI Nov. 1924 (9)*

11. Lamb & Son were engaged in business under the name of Alpha Paper Works. They became insolvent. They entered into an agreement, in the nature of a deed of trust, with their creditors under which certain creditors, as trustees, were to carry on the business under the name Alpha Paper Company, were to divide the profits among the creditors pro rata and, when all were paid, were to return the business to the original proprietors. The trustees, as such, gave a note to one Reim, who, upon nonpayment of the note, sued the creditors alleging them to be partners in the conduct of Alpha Paper Company. What should be the decision? *AI Nov. 1929 (2)*

12. You are in the employ of Jones & Co., a copartnership engaged in the stockbrokerage business. Your employers offer to compensate you for your services by a share in the profits of the business. An agreement is submitted to you to carry out the offer. Before you sign the agreement, and for your protection, what, if any, provisions should you insist upon including in the agreement other than those relating to your sharing in the profits? *AI May 1929 (6)*

13. Distinguish between a general partnership and a business corporation. Answer fully. *NY May 1927 (7)*

14. What risks would you deem to be important for careful consideration before you would enter into copartnership with another? *AI May 1927 (12)*

15. *A* and *B* enter into an agreement to unite all of their property of every description, also their services, in carrying out a grocery business for their joint profit. What relation is created? *A* and *B* enter into an agreement whereby each contributes \$2000 and his services in establishing and carrying on a shoe store for their joint profit. What relation is created between *A* and *B*? *A* and *B* unite their money and services in purchase and resale of a certain lot of machinery for their joint profit. What relation is created between *A* and *B*? *NY June 1916 (11)*

16. Compare a co-ownership and copartnership and state in what way they differ. *NY June 1923 (4)*

17. State briefly the difference between a joint venture and a business partnership. *NY June 1924 (6)*

18. State the liability to firm creditors of each of the following classes of persons: (a) general partner, (b) special partner, (c) member of a voluntary or joint-stock association. *NY May 1927 (5)*

19. Describe general, special, ostensible, secret and silent partners. *AI Nov. 1918 (Part 2)*

20. Tompkins and Sheehan agreed to engage, as partners, in the business of manufacturing radio apparatus, the business to be conducted in Tompkins's name. Tompkins bought certain goods for use in the manufacturing business, the seller knowing nothing regarding the partnership. Subsequently, the business failed and the seller, hearing about the partnership, sought to hold Sheehan. Could he do so? *AI May 1924 (9)*

21. Define dormant partner, limited partnership, general partner, trading partnership, ostensible partner. *AI Nov. 1927 (10)*

22. Illustrate equitable estoppel in connection with a partnership transaction. *NY Nov. 1929 (9)*

23. Is it possible for a partnership to exist between parties who do not consider themselves partners? *AI Nov. 1925 (I-3)*

24. (a) In examination of the business books of a partnership, for what document would you inquire for confirmation of the division of profits and amount of capital of the several members?

(b) Describe several other important provisions that you would expect to find in such a document. *AI May 1919 (11)*

25. State the provision of the State law respecting fictitious firm names. *NY Jan. 1924 (13); NY Jan. 1920 (6)*

26. (a) What is meant by the term *partnership capital*?

(b) Distinguish between partnership capital and partnership property.

(c) What may be contributed to the partnership as capital? *NY Apr. 1934 (2)*

27. Is there any difference between the capital contribution of a general partner and that of a special partner? Give reasons. *NY May 1930 (2); NY Nov. 1927 (2)*

28. Where one partner furnishes the capital and the other the skill, should interest be allowed on the capital? If the business ceases to be carried on and there is a loss, is it proper in ascertaining the liability of the partner not furnishing the money, though liable for a loss, to charge interest on his share? *NY June 1920 (5)*

29. What is the nature of the interest of a partner in partnership property? In what manner may a partner's interest be ascertained and made available? *NY June 1923 (2)*

30. Robert MacFarlane died, and in his will he gave to his two sons, Robert, Jr. and William, his property at No. 24 A Street, with all the machinery, fixtures and implements connected with it and used in the dyeing business, each son to share equally. The two sons went into possession of the property and for two years conducted the business, dividing the profits equally. Then Robert, becoming dissatisfied, began an action against William for the partition of the real property (partition being an action by which real estate alone may be divided between co-owners). William defended on the grounds that he and his brother were partners and that until the copartnership was wound up, creditors were paid and the partners' interests adjusted, the property at No. 24 A Street was personality and could not be the subject of a partition action. Was William's defense good? *AI May 1924 (8)*

31. X acquired the interest of A in the copartnership of A and B by purchase at a sale under execution issued on a judgment against A individually. Subsequently, A and B gave a chattel mortgage on firm property to Y, a firm creditor. Were X's rights in the property superior to Y's or vice versa? *AI May 1922 (8)*

32. Mullen and Gage, partners in a manufacturing business, purchased a factory site. Gage died during the existence of the partnership. In a state where dower is recognized, has his widow any dower or other right in this land? *AI May 1931 (8)*

33. To what extent is a partner liable to his copartners for losses incurred in his conduct of partnership transactions? *AI May 1925 (9)*

34. In January 1918, A, B and C entered into a partnership agreement for the purpose of bringing about the sale on a commission basis of a large manufacturing plant, each of the three to share equally in any commissions earned and no time limit being ex-

pressed in the agreement. *A*, having the closest personal relations with the owners of the plant, entered into negotiations which continued with incidental assistance from *B* and *C* through 1918, 1919 and part of 1920. Due to differences of opinion among the owners of the plant, the negotiations were not successful, and in March 1920, the owners wrote to *A* that they had decided not to entertain a proposition for sale at that time. *B* and *C*, upon considering this letter, wrote *A* that, as they deemed the negotiations closed, the agreement of January 1918 between the three must be considered terminated. *A* then wrote to *B* and *C* stating that before terminating the agreement he desired a further conference between the three. To this letter neither *B* nor *C* replied. In August 1920, *B* and *C* started negotiations, brought about a sale of the plant and received as commissions the sum of \$60,000. *A* thereupon sued *B* and *C* under the agreement of January 1918, for a partnership accounting and for one-third of the commissions earned. Could *A* recover? *AI Nov. 1921 (9)*

35. A firm of three members decided to dissolve and discontinue business. One of the members secretly obtained a lease of the property that the firm had occupied for many years, the new lease to begin when the old one expired. This member obtained the lease prior to the dissolution, but it was known at the time that dissolution was contemplated. After dissolution the member sold the lease at a large profit. The other partners immediately sued to recover a share of the profit thus made. Could they succeed? *AI Nov. 1926 (12)*

36. Smith, Jones and Robinson were copartners and were engaged in the business of buying and selling land. Jones, unknown to Smith and Robinson, bought and sold in his own name four parcels of land and made a profit of \$15,000 on the first transaction and sustained a loss of \$7,000 on each of the other deals. Smith and Robinson, on learning these facts, brought an action in equity to compel Jones to account for and turn over to the partnership their part of the profit of \$15,000 made on the first transaction. In view of the fact that Jones lost \$21,000 on the three remaining transactions, will such an action succeed? Explain. *NY Nov. 1926 (10)*

37. Smith, Howe & Rogers were partners engaged in the drygoods business. Smith and Rogers advocated the establishment in their store of a department for the sale of groceries and similar articles. Howe opposed the plan. Could Smith and Rogers overrule Howe's objection and, as the majority partners, proceed with their plan? *AI Nov. 1922 (9)*

38. What do you understand to be the meaning of the term *profits*? *NY June 1918 (10)*

39. (a) A partnership agreement contains no provision as to interest on profits not withdrawn from the business. Is a partner who leaves his profits in the business entitled to interest? Give

reasons. (b) If the firm is in need of money and one of the partners pays in \$5000, which amount is beyond the requirements of the agreement as to the capital to be contributed by him, is he entitled to interest on this amount as long as he keeps the money in the business? Explain. *NY Jan. 1916 (13)*

40. Jones, Johnson and Perry form a partnership. Jones contributes \$5000, Johnson \$3000 and Perry \$1000. The partnership agreement omits any provision indicating how the profits are to be divided. If the business results in profit, how will such profit be shared by the partners? *AI May 1930 (3)*

41. *A* and *B* enter into a partnership venture, *A* contributing one-third of the necessary capital and *B* contributing two-thirds. There is nothing said or agreed to as to how profits shall be divided. What is the proportion of profits that should go to each partner? *AI May 1926 (12)*

42. Is a surviving partner entitled to any compensation for winding up the affairs of his firm? Explain. *NY Jan. 1925 (6)*; *NY Jan. 1921 (5)*

43. *A* and *B* were partners in the hardware business. Because of illness, *B* was prevented from attending business for a period of several months, thereby throwing the burden of conducting the affairs of the copartnership entirely upon *A*. After *B*'s recovery, *A* demanded compensation at the rate of \$40 per week for the extra work that he had been compelled to do. Upon *B*'s refusal to comply with the demand, the partnership was ended and *A* sought to recover the amount demanded by suit. Could he succeed? *AI Nov. 1922 (8)*

44. *R* and *C* were partners engaged in the construction business. Their partnership was an oral one and profits and losses were to be equally divided between them. In an accounting between them, *R* claims to be entitled to receive interest on a loan made by him to the firm. Is *R*'s contention correct? Give reasons. *NY May 1929 (14)*

45. Have special agreements between partners as to partnership affairs any effect upon contracts between the partnership and other parties? *AI Nov. 1925 (II-7)*

46. A partner without consent of any of the other partners executed and delivered a mortgage on firm real estate using the proceeds to pay certain firm debts. Was the mortgage binding? *AI Nov. 1927 (11)*

47. Has a partner the right to make a general assignment of partnership property for the benefit of creditors without the knowledge of his copartners? *AI May 1926 (11)*

48. *G* and *H* were copartners engaged in the warehouse business. *H* issued a warehouse receipt that represented that the firm had 6500 bushels of wheat on storage for Nash & Son. On the credit of

the receipt, Nash & Son obtained a loan from Robbins of \$4000, the warehouse receipt being transferred to Robbins. Thereafter Robbins duly demanded the grain from *G* and *H*, when it was found that *H*, without knowledge of his copartner, had conspired with Nash & Son and had issued a false receipt. Robbins thereupon sued both *G* and *H*. Was *G* liable in any way? *AI May 1921 (9)*

49. What is the general liability of a partnership? *NY Jan. 1920 (7)*

50. To what extent are partners liable for the debts of the partnership? How are the partners liable, jointly, severally, or jointly and severally? Is the liability of a deceased partner binding on his estate? *NY Nov. 1931 (3)*

51. Distinguish between the liability to third persons of (a) a general partner, (b) a special partner. *NY May 1928 (2)*

52. *K* and *B* were partners. *K*, while engaged in the partnership business, was driving an automobile owned by the partnership and negligently injured *W*. *W* sued *K* and *B* individually and recovered judgment for \$450. *B* was never served with a summons in the action commenced by *W*. Subsequently, the partnership was dissolved by mutual consent and the firm assets became *K*'s property. *K* was compelled to pay *W* the \$450. *K* sues *B* to recover one-half of the sum paid *W*. Can he recover? Give reasons. *NY May 1930 (11); NY May 1928 (11)*

53. Is an incoming general partner in a partnership personally liable for payment of firm debts contracted before he became a general partner? Explain. *NY Nov. 1928 (2)*

54. *C* is admitted as a partner, in a partnership composed of *A* and *B*, on contributing a certain amount to the partnership capital. Prior to *C*'s admission, the partnership of *A* and *B* incurred a large obligation that, subsequent to *C*'s admission as a partner, the partnership assets were insufficient to satisfy. *A* and *B* having no financial responsibility, *X* seeks to satisfy his claim out of the individual assets of *C*. Can he succeed? *AI Nov. 1920 (10)*

55. *X* joins the firm of *A* and *B* as a partner. What is the liability assumed by *X*? *NY Apr. 1933 (3)*

56. Jones, Smith and Brown are partners engaged in the business of buying and selling real estate. The name of the firm is "Jones, Smith & Brown." Brown resigns and a new firm is formed composed of Jones and Smith, but the new firm continues to use as its firm name the name of "Jones, Smith & Brown." People who had been trading with the old firm were not notified of the dissolution. Six months later *X*, a person who had been trading with the original firm for a number of years prior to its dissolution and who did not know of its dissolution, entered into a contract with Jones on behalf of the new firm "Jones, Smith & Brown." The contract was breached by the new firm "Jones, Smith & Brown," and *X* was dam-

aged. Can *X* hold Jones, Smith and Brown individually responsible, or can he simply hold Jones and Smith individually? *AI May 1928 (10)*

57. *A* and *B* were copartners. They dissolved the partnership, *A* retiring from the business and *B* continuing it. After the dissolution, *B* continued to use the same offices, on the door of which *A*'s name remained, and also continued to use the firm's stationery, of all of which *A* had knowledge. Many concerns not knowing of the dissolution sold goods, as they supposed, to the firm. Upon the insolvency of *B*, they sought to hold *A* liable. Could they? *AI Nov. 1923 (8)*

58. One of three members retires from a firm, the two remaining members assuming, by written agreement, all responsibility for the then outstanding debts. Before these debts are paid a combination of unfortunate circumstances renders the new firm insolvent. Can the retiring partner be held for any part of the debts? *AI Nov. 1926 (2)*

59. The firm of *A* & *B* is dissolved by mutual consent. Notice of dissolution is published in all local newspapers. *C*, who has previously purchased goods from the firm on credit and who does not know of the dissolution, sells goods on 30 days to the partner remaining in the business, believing the partnership still to be in existence. On default in payment, he sues *B*, the retired partner, who defends on the ground that the partnership has been dissolved and that notice of the same has been published in the newspapers. In whose favor will judgment be given? *NY Nov. 1926 (11)*

60. Atwood and Chapin were partners and their business was insolvent. Atwood fraudulently represented to Morton that the firm's business was solvent and thereby induced Morton to become a partner and to make a capital investment of \$10,000. As soon as Morton discovered the fraud, he personally obtained possession of most of the firm's assets and then notified his partners that he had withdrawn from the firm. Thereafter, a creditor of the firm whose claim had arisen prior to Morton's becoming a partner, sued all three partners.

(a) What was the extent of Morton's liability, if any, to the creditor who was suing?

(b) What rights had Morton with respect to the fraud perpetrated on him? *AI Nov. 1931 (5)*

61. (a) If no time is expressly or impliedly specified in the articles of partnership for the time that the partnership will last, when may the partnership be terminated?

(b) Does the retirement of a partner or the admission of a new one to the firm operate to dissolve the existing partnership and cause the formation of a new partnership? *AI May 1928 (11)*

62. (a) What circumstances can cause the dissolution of a partnership?

(b) Does dissolution necessarily result in the actual termination of the business formerly conducted by the partnership?

(c) What authority has a partner after dissolution? *AI Nov. 1932 (9)*

63. Weeks and Matthews formed a copartnership for a five-year term. Soon after they began business, Matthews found that Weeks was engaging in wild speculations, was almost continually in a drunken state and was generally so conducting himself as to cause the firm to lose its good name and reputation. Had Matthews any remedy? *AI Nov. 1923 (9)*

64. *A* and *B* were partners in business. *A* died and *C* was appointed executor of his will. What are the rights, if any, of *C*, as executor, with respect to the partnership assets and business? *AI Nov. 1919 (12)*

65. *A* and *B* were copartners in the business of manufacturing shoes. *A* sold and conveyed his interest in the firm to *C*. What effect has the transfer on the partnership? What rights does *C*, the purchaser, acquire? *AI May 1920 (10)*

66. Under dissolution of the partnership, owing to the death of a partner, is the survivor, in the absence of an expressed agreement, entitled to continue the business or must he account for the good will and other assets to the representative of the deceased partner? *NY Jan. 1925 (3); NY June 1921 (2)*

67. A partnership is organized without any mention as to duration of the partnership. At the end of one year one of the partners serves notice on the other that he wants to retire from the firm and receive the value of his interest in the business. Can he compel the other partner to pay him out his share? Does he subject himself to any action for breach of partnership agreement in refusing to stay in the firm? Explain. *NY Jan. 1917 (11)*

68. *X*, *Y* and *Z* entered into a partnership that, by the provisions of the partnership agreement, was to continue for a term of three years. However, during the first year *Z* disagreed many times with *X* and *Y* as to business policies, such disagreements resulting in strained personal relations between the partners. At the close of the first year, *X* and *Y* decided to drop *Z* from the partnership and so informed him. Could *X* and *Y* compel *Z* to withdraw? *AI May 1930 (11)*

69. In 1916, *J* and *G* entered into a written agreement to become partners under the firm name of *J*'s Delicatessen Market, and thereafter continued in such business until *G*'s death, June 30, 1918. The agreement provided that the copartnership should continue for ten years from its date and that each of the partners should have a half interest in the partnership property and its affairs, each to be entitled to one-half of the profits and each liable for one-half of the losses. It was further agreed that *J* was to manage the business

and to devote his entire time thereto and to receive therefrom a salary of \$200 a month, payable weekly. On *G*'s death, *J* repudiated the agreement and took possession of the business and its assets under the claim of sole ownership and has since been conducting it for his own benefit. He refused to account to *B*, executor of *G*'s estate. *B* sues *J* for an accounting and contends that *G*'s estate is entitled to one-half of the profits and assets that accrued since the commencement of the partnership and that *J* is not entitled to compensation for services rendered as surviving partner after *G*'s death. *J* contends *G*'s estate is not entitled to one-half of the profits and that *J* is entitled to compensation for services rendered as surviving partner. Which is correct? Give reasons. *NY Nov. 1927 (13)*

70. Martin and McBride were copartners in a certain business. Martin sued McBride for supplies furnished to the latter by the former for the operation of an independent business carried on by McBride, entirely independent of the partnership. Could Martin recover? *AI May 1923 (9)*

71. *A*, *B* and *C* were partners. *A* contributed \$10,000 to the capital, *B* \$5000, and *C* contributed his skill. The partnership was terminated by the expiration of the time mentioned in the partnership agreement and, after all debts and liabilities to third persons were paid, it was found that \$3000 remained. There had been no capital withdrawals. How should the \$3000 be divided and what further adjustment, if any, should be made? *NY Jan. 1926 (1)*

72. In the voluntary dissolution of a partnership, in what order will the assets be distributed? *NY May 1928 (9)*

73. *A*, *B* and *C* form a partnership, each by mutual agreement contributing equally to the original capital. Later, *C* furnished various further sums to the partnership to prevent financial difficulties, the partnership finally being obliged to make an assignment for the benefit of its creditors. What are *C*'s rights with regard to the additional sums furnished by him? *AI Nov. 1920 (9)*

74. Brown, Coates and Danforth were partners sharing profits in proportions of one-fourth, one-third and five-twelfths, respectively. Their business failed and the firm was dissolved. At the time of dissolution, no financial adjustments among partners were necessary, but the firm's liabilities to creditors exceeded its assets by \$24,000. Without contributing any amount toward the payment of the liabilities, Coates moved to Europe, where he was not subject to legal process. Brown and Danforth are financially responsible. How much must each contribute? *AI Nov. 1930 (5)*

75. What are the rules that must be observed in adjusting the accounts of partners in liquidation,

(1) As to payment of losses;

(2) As to application of assets? *AI May 1918 (17)*

76. Can execution on a judgment against a copartnership be im-

mediately levied on property of one of the partners? *AI Nov. 1925 (I-9)*

77. State the rule for the marshaling of assets and payment of firm and individual debts where a copartnership becomes insolvent, the members thereof having personal assets and individual creditors. *AI May 1925 (8)*

78. Wherein do the rights of individual creditors and those of partnership creditors differ with respect to partnership funds? *NY Jan. 1918 (8)*

79. *A* and *B* are partners. *A* dies. The assets are found to be worth only 75% of its liabilities in liquidation. *A*'s estate is solvent, and *B* is insolvent. What are the rights of the firm's creditors against *A*'s assets not invested in the partnership, and what are the rights of *B*'s personal creditors as to the partnership assets? State the rule governing such cases. *AI Nov. 1917 (14)*

80. In May 1921, the firm of Baxter, Brady & Childs made a promissory note to A. W. Voorhis. Childs, a member of the firm, died in July 1921, and in September 1921, the note being due and unpaid, Voorhis brought action against Baxter, Brady and the executor of the deceased partner, Childs. Did the executor have any defense to the action? *AI Nov. 1921 (8)*

81. (a) Define and give an example of a limited partnership.

(b) May all partners in a limited partnership be limited partners?

(c) In what circumstances, if ever, can creditors hold a limited partner liable for partnership debts? *AI May 1932 (5)*

82. George B. Lewis was a special partner in the limited partnership of Bradley & Smith, his contribution to capital being the sum of \$50,000. Under the provisions of the copartnership agreement, the partnership expired January 6, 1921. On January 7, 1921, Lewis received from the firm the sum of \$50,000, thus withdrawing his contribution to capital. James A. Grant, to whom the firm had become indebted in the sum of \$75,000 and who had been unable to collect his debt, sued the copartnership in February 1921, naming as defendants both general partners and Lewis, the special partner. Did Lewis have any defense to the action? *AI May 1921 (8)*

83. *A*, *B* and *C* were general partners, each having contributed \$5000 to the capital. *D* was the limited partner, his contribution being \$15,000. During the period of the partnership, *A*, *B* and *C* each advanced to the firm, as loans, the sum of \$5000. Upon dissolution there remained, after payment of the firm creditors, only \$15,000. How should this amount be disposed of? *NY Nov. 1926 (12)*

CHAPTER VIII

Corporations

721. Scope of chapter. In this chapter we consider the nature, characteristics and classifications of corporations; their promotion, incorporation and organization; the capital stock of a corporation, including stock subscriptions, and the issuance and classification of shares; corporate management; the designation, powers, duties and liabilities of directors and officers; the rights, duties and liabilities of stockholders; the rights, duties, powers and liabilities of the corporation itself in dealing with the outside world; and, finally, the subject of corporate mergers, consolidations, receiverships and dissolution.

Uniform statutes. There are two uniform statutes dealing with corporations: the Uniform Stock Transfer Act (see pp. 12-13), which has been adopted in forty-one states, and the Uniform Business Corporation Act, which has been adopted in Idaho, Louisiana and Washington.

A. Nature and Characteristics

722. Definition and nature of corporation. A corporation, as defined by Chief Justice Marshall, is "an artificial being, invisible, intangible, and existing only in contemplation of law." It is a *fictitious person* adopted as a device whereby groups of individuals, large or small, may concentrate their efforts. It is endowed by law with many of the rights, duties, powers and liabilities of a natural person. Being an artificial or fictitious person, it can act only through human agency: *directors*, who are elected by owners or *shareholders*, and who guide its policies and elect its *officers*; the latter, in turn, selecting its administrative *agents* and *employees*.

723. Attributes of corporation. Corporations, regardless of type or class, have certain attributes that have an important bearing on the rights, powers, duties and liabilities of a corporation. Among these are the following: Creation by government franchise, existence as a legal entity and continuous succession.

724. Corporations are government creatures. Corporations are created by governmental authority. They cannot come into existence by mere contract, as in the case of partnerships. The right to exist as a corporation is sometimes referred to as a *primary franchise*, to distinguish it from a *secondary franchise*, such as the right subsequently acquired by certain corporations (sec. 736) to use public highways or city streets in connection with transportation, waterworks, gas, electric, telephone or telegraph services. A primary franchise is better known as a *charter*.

725. Corporation as legal entity. A corporation exists as a complete being, separate and apart from its incorporators, stockholders, directors, officers or employees. Corporate property belongs to the corporation, not to the stockholders; and corporate liabilities are the liabilities of a corporation, not of its stockholders.

Examples:

(1) If a person owns the entire capital stock of a corporation and nothing else, and such corporation owns nothing but real property, the stockholder does not own real property, but personal property; namely, shares of stock in the corporation.

(2) Button sued Hoffman for certain property belonging to a corporation. Button contended that the property belonged to him because he owned all the stock of the corporation that owned the property. The suit was dismissed. Button and the corporation, said the Court, were separate and distinct persons.¹

(3) See section 1627.

Where the legal entity of a corporation is utilized to perpetrate a fraud, the courts may disregard it (sec. 870).

726. Continuous succession. A corporation's existence continues, regardless of the death or incapacity of any of its directors, officers or employees, and regardless of changes in stockholder personnel. Corporate existence may continue forever (sec. 760).

727. Purposes for which corporations may be formed. A corporation may be formed for any lawful purpose, to do anything that a natural person may do. This rule is subject to certain exceptions (sec. 877).

728. Advantages of corporate form of doing business. We have already noted certain basic differences between partner-

¹ *Button v. Hoffman*, 61 Wis. 20.

ships and corporations (sec. 633). Corresponding with these differences are the basic advantages that corporations have over the individual or partnership form of doing business:

(1) *Limitation of liability: debts.* Persons conducting business as partners or individual proprietors may lose their all and go heavily into debt. Persons conducting business in corporate form risk liability only to the extent of the amount invested.

(2) *Limitation of liability: no agency.* Individual proprietors and partners are liable for all acts of their agents within the course and scope of their duties. Partners are additionally liable for the partnership acts of their copartners. Stockholders, as such, are in no sense agents of one another; neither is a stockholder personally liable for the acts of a corporation's directors, officers or employees.

(3) *Flexibility of financing.* Through the medium of widely distributed shares or units of ownership, it is possible to secure corporate financing on a larger scale than is the case with an individual or partnership undertaking.

(4) *Continuity of business.* A corporation, if its charter so provides, may continue business indefinitely, regardless of death or change of stockholders, and regardless of death or change of managing personnel. In the case of partnerships, on the other hand, the firm is terminated by the death or withdrawal of any of its members.

(5) *Transferability of interest.* If a person invests in an individual or partnership enterprise, it is not always easy for him to sell his interest in the business, and, when he does, the business as a rule suffers a violent change of management. The admission or withdrawal of a partner, for example, usually dissolves the firm. This is not true of a corporation. Stockholders need not even know one another. In thousands of corporate enterprises, hundreds of thousands of stockholders freely buy and sell their shares without in any way affecting continuity of management.

(6) *Concentration of business strength through right to act as entity.* Partnerships, to a greater or less degree, must still act as individuals, rather than as an entity. Corporations, as entities, enable large groups to concentrate their power and to exert more effectively their combined efforts and resources in the conduct of their business. A corporation may own property, make contracts, conduct business, sue and be sued, all as a single person and in its own name.

729. Disadvantages of corporate form of doing business. Among the disadvantages of the corporate form of doing business are the following:

(1) *Expense.* Persons must pay for the privilege of doing business in corporate form. The cost varies with the size of the corporation, amount of stock authorized and issued, amount of business done, and so on. The initial incorporation and organization expenses, including filing fees, organization taxes, attorney's fees, and so on, are relatively less burdensome on larger than on smaller corporations.

(2) *Taxation.* Many states have franchise taxes which must be paid annually for the privilege of doing business as a corporation. The tax burden, Federal and state, tends to be heavier in the case of corporations than with individuals and partnerships. Excess profits taxes constitute one example. Profits of a partnership, unlike those of a corporation, are apportionable among partners. Special corporate taxes and levies are not uncommon.

(3) *Scope of activity: charter limitations.* Individuals and firms may engage in any legitimate business, as their desires may dictate. A corporation may do only those things that are expressly or impliedly authorized in its charter. (See sec. 877.)

(4) *Right to do business in other states.* Natural persons, either as individuals or as members of a firm, have the constitutional right to conduct business in any state of the Union. This is not true of corporations. (See sec. 872.)

(5) *Government supervision.* Partnerships and individuals are free from the necessity imposed upon corporations of filing Federal and state returns concerning their activities, capital stock, director and officer personnel, and so on.

(6) *Right to practice profession.* Corporations, as pointed out in sec. 634, are generally forbidden to practice the professions.

730. Corporations distinguished from joint-stock associations. We have already noted certain resemblances and distinctions between joint-stock associations and partnerships (sec. 637). Joint-stock associations also resemble corporations in certain respects and differ from them in others.

(a) *Resemblances.* Joint-stock associations resemble corporations in the following respects:

(1) *Capital stock.* Joint-stock associations issue shares of stock against capital.

(2) *Continuous succession.* Joint-stock associations enjoy the corporate advantage of continuous succession (sec. 726).

(3) *Management.* Like corporations, joint-stock associations are managed by directors and officers.

(b) *Differences.* Joint-stock associations differ from corporations, and resemble partnerships, in the following respects:

(1) *Name in which suits may be brought and defended.* A joint-stock association sues or is sued in the names of its members, or in the name of its president or treasurer, not in its registered name.²

(2) *Personal liability.* Members of a joint-stock association are individually liable for its debts.

Joint-stock associations are sometimes formed by groups not desiring to incorporate, such as labor unions, trade associa-

² See, however, sec. 657.

tions, insurance underwriting groups, stock exchanges and co-operative stores.

B. Classification of Corporations

731. General classification. Corporations may be generally classified as follows:

- (1) Public and private
- (2) Domestic and foreign
- (3) *De jure* and *de facto*³
- (4) Corporations by estoppel.⁴

732. Public corporations. A public corporation is one created for governmental purposes. "The most important distinction between public and private corporations is with respect to governmental control. Public corporations, being mere instrumentalities of the state, are subject to governmental visitation and control, whereas the charter of a private corporation is a contract between the state and the corporation or incorporators, which, under the clause of the constitution of the United States prohibiting state laws impairing the obligations of contracts, renders such corporations not subject to visitation, control, or change by the state, except in the exercise of the police power."⁵ Theoretically, every government, Federal, state or local, is a corporation. However, the term "public corporation" is more commonly applied to a governmental division that has received a specific grant of corporate powers in the form of a charter, such as a *municipal* corporation or a *public benefit* corporation.

733. Municipal corporations. A municipal corporation is a political or governmental agency of the state that has been constituted for the local government of the territorial division described and that exercises, by delegation, a portion of the sovereign power for the public good. It is the creation of the legislature, which endows it with certain local governmental functions and imposes upon it the performance of certain duties.⁶ Although counties and towns have always been bodies corporate for certain purposes, they were, nevertheless, created primarily for purely governmental purposes, so that their cor-

³ See secs. 748-750.

⁴ See sec. 751.

⁵ 18 *Corpus Juris Secundum* 395.

⁶ *MacMullen v. City of Middletown*, 187 N.Y. 37, 41, 43.

porate powers were of defined and limited extent. A city, however, is a different type of municipal corporation. It is created by charter, is granted power to own and manage private property and is invested with particular franchises for the accomplishment of its expressed functions. On the other hand, a county or town is created as part of the scheme of state government, and it exercises certain political powers as one of the state's civil divisions.⁷

A municipal charter is not a contract (sec. 1632, subd. d).

In some states, municipal corporations are defined by statute. For example, in New York, the General Corporation Law (sec. 3) defines a municipal corporation as including a county, town, school district, village, city and any other territorial division of the state established by law with powers of local government.

Municipal corporations, with certain exceptions, are formed in the same way as other corporations, subject to different procedures (sec. 1632, subd. b). Unlike other corporations, however, they function, not through directors elected by members or shareholders and through officers elected by directors, but through publicly elected officials (sec. 1631, subd. d). They therefore present radically different problems from those affecting private corporations.⁸

734. Public benefit corporations. Public benefit corporations are organized to construct or operate a public improvement wholly or partly within a state, such as a bridge or a tunnel, the profits from such improvement to inure to the benefit of the state or states thus served.

735. Quasi corporations. The word "quasi" means "as if." Some bodies are not exactly corporations but are treated as if they were. Incorporated cities and villages, for example, are

⁷ *Nassau County v. Lincer, et al.*, 165 Misc. 909, 3 N.Y. Supp. 2d, 327, 333.

⁸ For example, the validity of a bond issue by a private corporation may be simply determined by an examination of the charter and the authorizing resolution. In determining whether a municipal bond issue is valid, however, the following questions arise: (1) Whether the municipality was authorized to issue the bonds for the purpose under consideration; (2) whether the debt limit has been exceeded; (3) whether the preliminary steps required by law have been taken; (4) whether proper provision has been made for the payment of the bonds; (5) whether the bonds are in proper form; (6) whether they have been duly executed and delivered by the proper officers; and (7) whether they have been sold or disposed of in accordance with law. 44 *Corpus Juris* 1226.

clothed with full corporate powers and are therefore corporations in the proper sense. A county, on the other hand, or a board of county commissioners representing the county, is not clothed with full corporate powers but may exercise corporate powers for some purposes, as for the purpose of holding property and making contracts for county purposes or for the purpose of suing and being sued. Because of its imperfect powers, such a body is not a corporation in the proper sense, but since it has some corporate powers, it is treated as if it were a corporation, hence is known as a *quasi corporation*. The same might apply to public boards, such as boards of school trustees, boards of education, and the like.

736. Quasi public ("public utility") corporations. A quasi public corporation is one engaged in rendering service of such general public importance as to justify the privilege of *eminent domain* (sec. 68) and amenability to public regulation under the *police power* (sec. 67).

Examples: Common carriers, water works, gas, electric, telephone and telegraph companies, and all companies coming generally within the classification of *public service* or *public utility* corporations.

737. Private corporations. Private corporations are those organized for nongovernmental purposes. They embrace *stock* and *nonstock* corporations.

738. Stock corporations. A stock corporation is one having shares of stock, and authorized by law to distribute dividends to the holders of such shares. Stock corporations are variously classified in the different states, according to statute. Under the New York statute they are classified as follows:

(1) *Moneyed corporations:* Formed under or subject to the Banking Law or the Insurance Law.

(2) *Railroad corporations:* Engaged in railway transportation and organized under the Railroad Law.

(3) *Transportation corporations:* Organized under or subject to the Transportation Corporations Law, and actually embracing nontransportation as well as transportation companies, such as gas, electric, telegraph, telephone, waterworks, omnibus, ferry, pipe-line, freight-terminal and district steam corporations.

(4) *Business corporations:* Engaged in general manufacturing, commercial or industrial activity for profit.

(5) *Co-operative corporations:* Such as producers' or consumers' co-operative stock corporations.

739. Nonstock corporations. Nonstock corporations are those that do not issue stock, such as:

(1) *Religious corporations*: Organized for religious purposes.

(2) *Membership corporations*: Including incorporated clubs, hospitals, colleges, benevolent societies, fire companies, cemetery corporations, bar and medical associations, boards of trade, and so on.

740. Domestic and foreign corporations. A corporation doing business in the state where it was incorporated is known in that state as a *domestic* corporation. All other corporations in that state are *foreign* corporations. (See secs. 873-876.)

C. Promotion

741. Promoter defined. A promoter is one who undertakes to form a corporation, or cause it to be formed, for a specified purpose or purposes, and who further undertakes to procure for the corporation the capital, rights, property and organization necessary to achieve such purpose or purposes.

742. Promoters' profits. Promoters are self-appointed agents of the corporation they undertake to form. Before the corporation comes into functioning existence, with directors and officers to safeguard its interests, promoters are in a position to dictate the way the corporation is to be formed, how it is to be organized, how capital is to be raised, the price at which stock is to be sold, and so on. The position of promoters, therefore, in relation to the corporation and to the stockholders, is highly fiduciary. Hence, promoters will not be permitted to take advantage of their position and to make secret profits at the expense of the corporation or its subscribers.

743. When corporation bound by promoter's contracts. Corporations come into existence unfettered by contract obligations. A corporation is, therefore, not bound by any agreement made by a promoter on its behalf, unless and until the corporation approves the agreement. If the corporation fails to approve the agreement, the promoter alone is bound.

Examples:

(1) The directors of the XYZ Corporation, notwithstanding a large net profit, decide not to declare a dividend. Smith claims that prior to incorporation, K, one of the promoters, made dividend promises contrary to the present acts of the directors. Such promises, unless subsequently approved by the corporation, are in no way binding upon it.

(2) See sec. 1641.

744. **Adoption v. ratification.** Since the acts of a promoter are not for himself, but for the proposed corporation, they constitute acts of an agent without an existing principal. Hence, contracts made for a corporation before it comes into existence are said to be *adopted*, rather than ratified, upon subsequent corporate approval.

745. **Express v. implied adoption.** Corporate adoption should be reflected in the *minutes* (secs. 798 and 842). However, though not so expressed, it may be inferred from corporate conduct.

Example: Four promoters retained Morgan as accountant to inaugurate a bookkeeping system for a corporation to be organized. They promised that the corporation would pay Morgan by issuing to him 25 shares of its stock. Upon incorporation, Morgan, with the knowledge and approval of the officers of the corporation (who had been its promoters), performed the services as agreed, but the corporation refused to issue the 25 shares as promised. The Court held that the facts themselves spelled out an adoption.⁹

D. Incorporation

746. **Source of authority.** The sovereign power to grant corporate charters is vested in the states. The Federal Government has no power to grant corporate charters except as to territory under its jurisdiction, such as the District of Columbia, and except as an incident to the conduct of its own business. Thus, Congress has power to create a corporation as a means of executing a Federal power conferred by the Constitution. Examples are the Emergency Fleet Corporation, National Banks, Federal Reserve Banks, Federal Deposit Insurance Corporation, Federal Farm Mortgage Corporation, Production Credit Corporations, Federal and Savings Loan Insurance Corporation and the Home Owners' Loan Corporation.

Originally, every corporate franchise (sec. 724) required a special statute. Today, except in special cases, corporations are formed merely by complying with the provisions of a general statute.

Right to repeal, alter or amend. In the famous Dartmouth College Case,¹⁰ Chief Justice Marshall held that a charter was a contract, and that no state, having granted a charter, could repeal, alter or amend it without violating the constitutional provision against impairing the obligation of

⁹ *Morgan v. Bon Bon Company*, 222 N.Y. 22.

¹⁰ *Dartmouth College v. Woodward*, 4 Wheat. (U.S.) 518, 636.

contracts. As a result, most if not all state constitutions provide that corporate charters shall not be granted outright (as in the Dartmouth College Case), but shall be subject to the right of the state at any time to repeal, alter or amend.

747. Failure to comply with incorporation laws. Broadly speaking, corporations cannot come into existence except upon compliance with incorporation laws. To this rule, however, there are several exceptions, including *de facto* as distinguished from *de jure* corporations, and corporations by *estoppel*.

748. De jure and de facto corporations. A *de jure* corporation is one duly and properly formed under the law. A *de facto* corporation is one not so formed, yet deemed in fact to exist for certain purposes, provided the following elements are present:

- (1) There is a law in existence under which such a corporation can be formed;
- (2) There has been some colorable attempt to comply with such law, i.e., a bona fide attempt to organize; and
- (3) There has been an exercise or use of corporate powers.

Failure to file certificate. "A corporation ordinarily may have *de facto* existence although it fails to comply with statutory provisions relating to the filing or recording of the articles or certificate of incorporation, or of the charter, provided there is a bona fide attempt to comply with such requirements and a colorable compliance; otherwise not."¹¹

Colorable compliance does not mean substantial compliance; rather, good faith is the test.

Examples:

(1) Three incorporators retain an attorney who prepares a certificate of incorporation. The incorporators execute it, with instructions to one of them to take it to the lawyer for filing. The incorporator forgets to do so; the lawyer assumes that the incorporators have dropped the matter; and in the meantime the other incorporators make various contracts on behalf of the corporation. These facts might justify recognition of *de facto* existence. There was a "colorable" attempt to comply. Bad faith was wholly absent. (See sec. 1638.)

(2) In *Culkin v. Hillside Restaurant, Inc.*,¹² a certificate of incorporation was not filed with the secretary of state; no fees were tendered; no payment of capital stock was made; there were no meetings of stockholders or directors; no officers were elected; and the only exercise of corporate powers was the opening of a bank account. The Court, finding that the associates deliberately refrained from taking the steps prescribed by law, refused to recognize *de facto* existence and held the associates liable as partners.

Collateral attack. An attack upon the validity of a corporation's exist-

¹¹ 18 *Corpus Juris Secundum* 498.

¹² 126 N.J. Eq. 97.

ence is "collateral" if made by anyone other than the state. The corporate existence of a *de jure* corporation may be challenged by no one, not even the state, so long as the corporation continues to comply with the law. The corporate existence of a *de facto* corporation may be questioned by the state, but by no one else; that is, it is not subject to collateral attack.

Examples:

(1) A certificate of incorporation is duly filed with the secretary of state, all filing fees and organization taxes are paid, stock is issued, directors and officers are elected, business is commenced, and then it is discovered that the certificate is defective, in that the notary who took the acknowledgment was not qualified to do so, his term having expired. Only the secretary of state can challenge the *de facto* existence of such a corporation.

(2) A *de facto* corporation issued stock in exchange for property. A personal creditor of the stockholders sought to levy execution on the property, on the ground that the corporation had no valid existence, hence no right to the property. Since the legality of a *de facto* corporation cannot be attacked collaterally, the levy was unsuccessful.¹³

749. De facto existence unaffected by acts subsequent to incorporation. The *de facto* character of a corporation is due to some irregularity prior to or in the course of incorporation. Hence, a *de facto* corporation does not cease to be such because of something done or not done *after* incorporation.

Example: If a *de facto* corporation fails to issue voting stock after incorporation, it does not on that account lose its *de facto* existence, though a failure to function may lead to forfeiture of its charter. (See sec. 1637.)

750. De facto corporations: no personal liability. Where the law recognizes the *de facto* existence of a corporation, its officers and employees cannot be personally held for debts incurred on its behalf.

Example: A corporation was duly organized in every respect except that the addresses of the initial subscribers to the stock were inadvertently omitted from the certificate of incorporation. Subsequently, a creditor, denying that the corporation had valid existence, sought to hold the incorporators (who later became directors and officers) personally liable on the debt. Since *de facto* existence cannot be collaterally attacked, the suit must fail.

751. Corporations by estoppel. Even where the elements of a *de facto* corporation are missing, a corporation may be deemed to exist for the purposes of a given transaction if the principle of *estoppel* (sec. 103) would make it unjust to allow a denial of corporate existence.

¹³ *Thies v. Weible*, 126 Neb. 720, 254 N.W. 420.

Examples:

(1) *Where persons purport to act on behalf of a nonexistent corporation, and later seek to deny corporate existence.* Arnold, Bates and Church contract with Dalton in behalf of the ABC Company, Inc., which exists as a trade name ("ABC Company") but not as a corporation. Dalton sues ABC Company, Inc. as a corporation. Arnold, Bates and Church are estopped to deny the corporate existence of such company.

(2) *Where persons deal with a nonexistent corporation as if it existed, then seek to deny liability to such corporation on the ground that it does not exist.* In the preceding illustration, Dalton, if sued by ABC Company, Inc., would be estopped to deny its corporate existence.

(3) *Where persons purporting to act for a nonexistent corporation are charged with personal liability when the nonexistence of the corporation is disclosed.* Using the illustration given above, Dalton, after dealing with ABC Company, Inc. as if it were a corporation, seeks to hold Arnold, Bates and Church personally liable as partners, or at least as joint principals, on the ground that ABC Company, Inc. is not really a corporation. Is Dalton estopped from denying corporate existence and from seeking to hold Arnold, Bates and Church personally liable? Some cases say yes, others no. Majority view: Persons cannot shelter themselves behind the doctrine of estoppel, and escape personal liability, by inducing strangers to contract with a pretended corporation.

752. No existence de jure, de facto, or by estoppel: personal liability. "Where an association has no corporate existence either de jure or de facto, and there is no estoppel, it cannot do any act whatever as a legal entity. It cannot take title to real or to personal property, convey real property, * * * acquire rights by contract or otherwise, incur debts or other liabilities either in contract or in tort, sue or be sued."¹⁴ In such cases the associates are personally liable as partners. (See sec. 748, Example 2.)

753. Steps in formation of stock corporation. The term *incorporation* is generally applied to the steps necessary for the formation of a corporation. These steps may vary slightly with the type of corporation. We may take as an example the formation of a business stock corporation under the New York statute. In the formation of such a corporation three steps are involved:

- (1) Preparation of the certificate of incorporation.
- (2) Filing and payment of taxes and fees.
- (3) Organization:
 - (a) Meeting of incorporators.
 - (b) First meeting of directors.

¹⁴ 18 *Corpus Juris Secundum* 488.

754. Qualifications of incorporators. Qualifications of incorporators vary. In New York, any three or more persons of full age may form a corporation, provided two-thirds of them are United States citizens and one of them is a resident of the state.¹⁵

755. Certificate of incorporation: contents. Except for minor variations, the required contents of a certificate of incorporation are fairly uniform in the different states.¹⁶ They usually embrace:

- (1) The proposed *name* of the corporation.
- (2) The *purpose* for which it is to be formed.
- (3) The amount of its *capital stock* as well as the various classes of such stock to be issued.
- (4) The principal *place of business* of the proposed corporation.
- (5) Its *duration*.
- (6) The *number of directors* (not less than three).
- (7) The *names and addresses* of the *directors* to serve until the first annual meeting of stockholders.
- (8) The names and addresses of the *subscribers to the stock* together with a statement of the number of shares each subscriber agrees to take.
- (9) The name of the agent for the corporation upon whom process may be served, or a designation of the secretary of state as such agent.

756. Corporate name. Every corporation must have a name. Such name remains the property of the corporation as long as the corporation continues to exist. The corporation may, however, change its name by complying with the statutory requirements for change of name. Under the common law a corporation could have adopted any name. Statutory provisions now place restrictions upon the use of corporate names. These restrictions vary. The most common restrictions relate to (1) similarity, (2) indication of corporate character, and (3) prohibition against certain words as part of the corporate name.

(1) *Similarity of names.* Incorporators generally ascertain in advance from the secretary of state whether the proposed name of the corporation is acceptable. The secretary of state will reject a certificate if the name too closely resembles that of an existing corporation. Approval by the secretary of state constitutes no guaranty that use of the name will not be

¹⁵ The requirement that one of the incorporators must be a resident of the state obtains in only eighteen of the fifty-three states and territories. The Uniform Business Corporation Act omits it.

¹⁶ The comment in secs. 755-764 in reference to the contents of such certificate is substantially applicable to incorporations generally.

enjoined by the courts as too similar to an existing name. As the following examples indicate, it is difficult to lay down a fixed rule as to when names will be prohibited as too similar, and when not:

Examples of Injunctions Granted:

(1) "Carnation Ice Cream Company" and "Carnation Milk Products Company."¹⁷

(2) "Transamerica Corporation" and "Transamerica Service Corporation."¹⁸

(3) "Chas. S. Higgins Co." and "Higgins Soap Company."¹⁹

Examples of Injunctions Not Granted:

(1) "Corning Glass Works" and "The Corning Cut Glass Company."²⁰

(2) "Bellingham Publishing Company" and "Bellingham American Publishing Company."²¹

(3) "International Diamond Drill Contracting Company" and "Diamond Drill Contracting Company."²²

(4) "Shredded Foods Company" and "Shredded Wheat Company."²³

(2) *Words or abbreviations indicating corporate character.* In most states, business corporations must contain words or abbreviations that clearly indicate that the name is that of a corporation, as distinguished from a natural person or a partnership. Such words or abbreviations are "Corporation," "Corp.," "Incorporated," or "Inc."

(3) *Prohibited words.* Ordinary business corporations must not give the impression that they are financial institutions. Hence, such words as "bank," "trust," "surety," and so on, may not be used in the name of an ordinary business corporation. In some states (Pennsylvania, for example) the statute prohibits the registration of names containing the word "state." Hence, the name "Keystone State Moving Picture Operators Association" was held to violate the statute.²⁴

757. Objects and powers of corporations. The *object* of a corporation is the business purpose for which it is formed; for example, the object of a real estate corporation is to deal in real estate. The *powers* of a corporation are the things that a corporation may do to achieve its object; for example, the power of a real estate corporation to issue a note or purchase land. The franchise or charter granted by the state gives the corporation its power to do business as a corporation for the purposes specified in the charter. The nature of the business

¹⁷ *State v. Hinkle*, 139 Wash. 651, 247 P. 1029.

¹⁸ *Cranford v. Jordan*, 7 Cal. 2d 465, 61 P. 2d 45.

¹⁹ *Chas. S. Higgins Co. v. Higgins Soap Company*, 164 N.Y. 462.

²⁰ *Corning Glass Works v. The Corning Cut Glass Company*, 197 N.Y. 173.

²¹ *State v. Hinkle*, 120 Wash. 85, 206 P. 942.

²² *Diamond Drill Contracting Co. v. International Diamond Drill Contracting Co.*, 106 Wash. 72, 179 P. 120.

²³ *Rexford v. Jordan*, 214 Cal. App. 547, 6 P. 2d 959.

²⁴ *Horowitz v. Beamish*, 323 Pa. 273, 185 A. 760.

to be carried on by the corporation must accordingly be set forth in what is known as the "purpose clause" of the certificate of incorporation, which in reality specifies not only the objects and purposes of the corporation, but its powers as well. *Express powers* are those specifically set forth in the charter. *Implied powers* are those inferred from the express powers as necessarily incidental to corporate existence and the conduct of the business. (See sec. 877.)

758. Capital stock. The certificate of incorporation must set forth the kinds and amounts of capital stock that the corporation is authorized to issue in exchange for capital. The nature of capital stock, its different classifications and the purposes for which it may be issued are discussed in secs. 770-787.

759. Location. The location of the principal office of the corporation must be set forth in the certificate because the law requires that corporate books and records be kept at the principal offices of the corporation. Such books and records must be available for inspection by stockholders and judgment creditors, and the officers of the corporation must have a specified place of business where they may be served with process should occasion arise.

760. Duration. Formerly it was the custom to fix a given number of years as the duration of a corporation's existence. It is now common practice to specify in the certificate of incorporation that the duration of corporate existence shall be perpetual.

761. Original directors. The certificate must set forth the name and address of each director who is to serve either during the first year or, as is now commonly provided in New York and other states, until the first annual meeting of stockholders.

762. Subscribers to stock. The names and addresses of each subscriber to the certificate of incorporation and a statement of the number of shares of stock that he agrees to take, must be set forth in the certificate. There is no specific requirement, however, as to the number of shares that a subscriber must take.

763. Designation of agent for service of process. In suits against a corporation, the summons or other process may be served on an officer, director or managing agent. It has often been difficult to secure service of process on a corporation be-

cause of difficulty in locating an officer. Hence statutes frequently provide that the certificate of incorporation must designate the name of the agent for the corporation upon whom process may be served, or the secretary of state as agent for such purpose.

764. Signature and acknowledgment. Incorporators must sign the certificate of incorporation at the end, and must acknowledge their signature before a notary public or other person authorized to take oaths. The acknowledgment is for the purpose of authenticating the signature and to prevent forgery.

765. Filing the certificate: fees and taxes. The certificate of incorporation is usually filed with the secretary of state or other corresponding official, and a certified copy filed with the county clerk or corresponding official having charge of the county records in the county where the corporation is to have its principal place of business. Upon such filing and the payment of required fees and taxes, the corporation comes into existence. No corporation may exercise any corporate powers or privileges until such taxes and fees have been paid.

E. Organization

766. Organization defined. The organization of a corporation embraces the steps necessary to enable the corporation to transact business by the selection of its managing personnel, the adoption of by-laws and the taking of various other preliminary steps. These steps are usually accomplished at a first meeting of incorporators and a first meeting of directors.

767. First meeting of incorporators. The first meeting of incorporators is held at a time and place fixed either pursuant to a written call, or by a written "waiver of notice" signed by all the incorporators. If the incorporators are "dummies," that is, nominees of the true parties in interest, they tender assignments of their stock subscriptions to the true stockholders in interest. If the directors are dummies, they tender their resignations and the directors who are actually to serve are elected in their place. It is also customary at the organization meeting for corporate resolutions to be adopted for the purpose of enabling the corporation to start functioning; such as resolutions authorizing the issuance of stock for cash or other property; resolutions for the acquisition of a business or business

property in exchange for stock or cash, such as a store, plant, machinery, patents and good will; resolutions designating a bank or banks as depositories of corporate funds; and resolution covering any other matters necessary to enable the corporation to begin functioning.

768. By-laws. One of the most important steps in organizing a corporation is to adopt by-laws, which govern the conduct of the corporation by specifying the duties and powers of officers, the time and manner of holding meetings, the fiscal year of the corporation, and so on. At common law, only the members or stockholders could adopt, rescind, alter or amend by-laws. Under the law today, directors are generally authorized to adopt by-laws for the corporation, subject to by-laws, if any, adopted by the members or stockholders. By-laws are binding on the corporation, its officers and directors. They have the binding force of a contract. No by-laws may be adopted, amended or rescinded so as to impair vested rights (see *Example*, sec. 837).

769. First meeting of directors. This usually follows immediately after the first meeting of incorporators. The directors elect officers, and the corporation is then ready to do business.

F. Ownership: Capital Stock

770. Capital *v.* capital stock. Capital, as applied to corporations, means the value of the property actually received for stock issued by the corporation. Thus, if \$50,000 has been paid into the treasury of a corporation against stock issued, the capital of the corporation is \$50,000.

Capital stock, in its strict sense, is substantially synonymous with capital. In everyday practice, however, capital stock has come to mean not only the aggregate of a corporation's assets but also a convenient mode of expressing collective ownership. It is because capital stock is supposed to reflect the aggregate of a corporation's assets that the law rigorously insists that it may be issued only in exchange for equivalent value.

Capital stock is fixed, capital assets may vary. If, after a corporation starts business, its net assets remain the same as its capital stock, the result is neither surplus nor deficit. If the net assets exceed the capital stock, there is a surplus; if they shrink below the amount of the capital stock, there is a deficit.

771. Share of stock: nature of. A share of stock is the interest or right that the holder has in the corporation. It gives the holder no right to the property of the corporation because that belongs to the corporation itself. In other words, a share of stock is not a physical piece or fraction of the corporate property, but rather a *right or collection of rights* in respect to the corporation.

772. Shares of stock: how issued. Shares of stock are issued in the form of *stock certificates*. These designate the name of the holder, the number and kind of shares issued to him, and the date of issuance. A certificate of stock is not valid unless signed by the proper officers of the company, with corporate seal affixed. Once issued, stock may be transferred in various ways (sec. 836).

Bearer shares. When a certificate of stock is made out to bearer, the shares are known as *bearer shares* (sec. 1664, subd. b).

Closed corporation: family corporation. A corporation whose capital stock is held by a limited group is known as a *closed corporation*. When the limited group are members of the same family, the corporation is known as a *family corporation*.

773. Par value and no-par value stock. Stock that is given a fixed arbitrary value is called *par value stock*. Stock that has no fixed value is known as *no-par value stock*. The rights and privileges of the holders of par value stock are the same as those who hold no-par value stock; that is, the distinction between the two is not a distinction of rights and privileges of the stockholders but of the form of issuance and the stockholder's liability in connection with it (sec. 787).

774. "Authorized," "issued," "outstanding," and "treasury" stock. The maximum amount of capital stock that a corporation is authorized by its charter to issue is known as its *authorized capital stock*. Any part of such stock for which a certificate has been made out and delivered is known as *issued stock*. Issued stock in the hands of stockholders is known as *outstanding stock*. Issued stock returned to or reacquired by the corporation is known as *treasury stock*.

Treasury stock: how acquired. A corporation may acquire its own stock by purchase, by donation, in extinguishment of a debt, and as a forfeited pledge or collateral.

Treasury stock purchasable only out of surplus. A corporation may purchase its own stock only out of surplus. To do otherwise would preju-

dice the rights of creditors. If a corporation disposed of all its capital assets in buying up all its outstanding stock, there would be nothing left with which to pay creditors.

No right to vote treasury stock. A corporation cannot, in any true sense, be a stockholder in itself. Hence, it cannot vote its treasury stock, whether held by the treasurer, trustee, or other official on behalf of the corporation.

775. Classes of stock: in general. The different classes of ownership interest and the rights, privileges, limitations or liabilities that go with each class are as set forth in the certificate of incorporation. Thus, the capital stock of a company may consist of *common stock* and *preferred stock*. The latter may be *cumulative* or *noncumulative*, *participating* and *nonparticipating*. Preferred stock may be subclassified as to various preferences, such as *first preferred*, *second preferred*, and so on. Ordinary stock may likewise have various classifications, such as *Class A*, *Class B*, and so on. However, none of these designations or classifications has meaning other than that defined in the certificate of incorporation. The usual provisions specifying the rights, privileges, limitations or liabilities of the different classes of stock commonly issued are set forth in secs. 776-779.

776. Common stock. The holder of this class of stock has, as a rule, a right to vote but no right to dividends unless the directors see fit to declare them.

777. Preferred stock. The holder of this class of stock, as the name implies, is usually given some kind of preference over another class of stock. The usual preferences relate to dividends and the distribution of assets upon dissolution.

Cumulative preferred stock. If a dividend is not earned on this class of stock, the obligation to pay it continues or accumulates until it is paid.

Example: The ABC Corporation has the following stock outstanding: 1000 shares of cumulative \$6-a-year preferred and 1000 shares of common. For five years it fails to earn or pay a dividend. In the sixth year it earns a profit of \$30,000. The directors propose to distribute \$25,000, as back dividends on the preferred, and \$5 per share on the common. This they cannot do. All past and current dividends on the cumulative preferred must be paid before any dividend can be paid on the common.

Unless the certificate of incorporation contains language indicating the contrary, dividends on preferred stock will be deemed cumulative.²⁵

Noncumulative preferred. If a dividend is not earned or declared on this class of stock in any given year, the obligation to pay it ceases. Even

²⁵ 18 *Corpus Juris Secundum* 661-662.

if enough is earned for such purpose, the directors may in their discretion pass the dividend, yet in a subsequent year declare and pay a dividend on the common stock without making good the passed dividend.

Example: Holders of noncumulative preferred stock (Class A), complaining that from 1915 to 1926 they had failed to receive their 5% dividends though earned, sued to restrain the directors of the Wabash Railway Company from declaring dividends on its Class B preferred and on its common stock until the back dividends on the Class A preferred were first paid. *Held*, for the directors. "When, as was the case here, the dividends in each fiscal year were declared to be non-cumulative and no net income could be so applied within the fiscal year referred to in the certificate, the right for that year was gone."²⁶

Participating and nonparticipating preferred. If earnings are more than sufficient to pay dividends on the preferred stock, the remainder may be given entirely to the common stock, in which case the preferred stock is nonparticipating; or such remainder may be distributed pro rata to both classes of the stock, in which case the preferred stock is said to "participate" with the common. Whether preferred stock is participating or not may be specifically stated in the articles of incorporation, or implied from language used in defining the stock, or prescribed by statute. In the absence of any indication one way or the other, the authorities are not in accord. Some hold that unless the contrary is indicated, preferred stock is participating: The fact that the dividend is guaranteed creates no inference that it is limited to the guaranteed amount. Other authorities hold that in the absence of provision to the contrary, preferred stock is nonparticipating: The guaranty of a fixed return is presumably accepted in lieu of equal participation.

Preference as to assets on dissolution. Holders of preferred stock have, as a rule, a preferred right to share in the distribution of assets on dissolution. If net assets on dissolution amount to \$100,000, and outstanding preferred and common amount to \$100,000 each, all the assets would go to the preferred stockholders, none to the common.

Preferences specified in a certificate of incorporation that relate to operations of the corporation as a going concern must not be confused with preferences that apply only to the distribution of assets upon dissolution or liquidation.

Example: A certificate of incorporation provided:

(Article A): Holders of preferred stock should be entitled out of surplus or net profits to cumulative dividends at 7%.

(Article E): In any liquidation or dissolution, preferred stockholders "shall be entitled to be paid in full the par value thereof and all unpaid dividends accrued thereon before any amount shall be paid or any assets distributed to the holders of the common shares."

(Article F): "The preferred stock shall be subject to redemption at \$110 per share plus all unpaid, accrued, or accumulated dividends thereon."

Upon dissolution, funds available for distribution, after payment to creditors, did not amount to the total par value of outstanding preferred

²⁶ *Wabash R. Co. v. Barclay*, 280 U.S. 197.

and common. The rule that dividends (Article A) and redemption premiums (Article F) are payable only out of surplus would not apply here, because only Article E is applicable to the distribution of assets upon dissolution, and such distribution is in no way dependent upon the existence of a surplus.

Voting rights. Preferred stock has the same voting rights as common unless the certificate of incorporation provides to the contrary. If voting power is vested only in the common, but preferred stock only is issued, the voting power shifts to the preferred (see sec. 1637). Normally, preferred stock is given no voting power. However, it is not uncommon for the charter to provide that voting power and management pass from the common to the preferred stockholders upon default in payment of preferred dividends.

Degrees of preference and priority. Statutes permit corporations to provide in their charters for the issuance of the same class of stock in various degrees of priority, such as *prior preference*, *ordinary preferred*, and so on, or *first preferred*, *second preferred*, and similar designations.

778. Redeemable ("callable") stock. Stock (usually preferred) is frequently issued subject to redemption at the option of either the corporation, the stockholder, or both, at a fixed price representing a premium above the price originally paid. Stock cannot be redeemed, however, if the rights of creditors are thereby prejudiced. Redeemable stock is sometimes said to be "callable."

Examples:

- (1) 5% prior preference, par \$100, callable at \$105.
- (2) \$3 preferred, no par, callable at \$55.

779. Convertible stock. Preferred stockholders may be given an option to exchange their stock for common stock, and vice versa. Likewise, preferred stock may be convertible into bonds, and vice versa.

780. Preferred stock *v.* bonds: relative advantage in financing. For the purpose of financing a new corporation, preferred stock is preferable to bonds in that the latter represent a fixed debt, repayable at a fixed time, with fixed interest obligations, default in which may result in suit, judgment, execution and levy (sec. 73). Preferred stockholders, on the other hand, are not creditors, but investors.

781. Stock subscriptions. A stock subscription is a contract to take and pay for a certain number of shares of the capital stock of a corporation already organized or to be organized. Before incorporation, stock of the proposed corporation may

be acquired only by subscription; after incorporation, it may be acquired either by subscription, or by purchase from the corporation or another stockholder. Formerly, it was customary to prepare a preliminary subscription list prior to incorporation, to make sure that the necessary capital would be forthcoming. The more common practice today is to organize the corporation first upon nominal subscriptions by the incorporators, and then, upon organization, to issue stock to the real parties in interest, against cash, property, services, the transfer of a business or other value. Then, if more capital is needed, subscriptions are solicited.

782. Legal effect of stock subscription. The legal effect of a stock subscription depends upon its terms. Ordinarily, a subscription is an offer to buy stock. It is not effective until accepted by the corporation; then it becomes a contract and the subscriber becomes a stockholder. A stock subscription should not be confused with a contract to purchase stock.

783. Stock subscription *v.* contract to purchase stock. A stock subscription is a definite offer that immediately ripens into a contract upon acceptance, regardless of whether a stock certificate is tendered or the purchase price paid. (See sec. 1656, subd. (b).) It is sometimes referred to as a *present subscription*. Upon acceptance of the subscription, the subscriber becomes liable, not merely on his subscription, *but as a stockholder*.

A contract to purchase stock, however, is not a present subscription but an executory agreement to subscribe for stock in the future. Mere acceptance by the corporation is not enough to make the prospective purchaser a stockholder. The purchaser in such case becomes liable *as a stockholder* only when the certificate is tendered and the price paid, and both these conditions are *concurrent* (sec. 217). If the purchaser refuses to accept and pay for the certificate, he is not liable as a *stockholder* but for breach of contract. If the corporation refuses to tender the certificate, it cannot be compelled to do so, but is liable in damages for failure to do it. If the purchaser fails to pay the entire amount due, he is not entitled to the stock nor to any dividend declared in the meantime.

Example: Plaintiff's assignor, a corporation, contracted to buy stock in an existing corporation but failed to pay the entire amount due. Plaintiff sued for dividends declared after purchase. The Supreme Court of Penn-

sylvania pointed out that the alleged subscriptions were "simply contracts of purchase and sale," and that the failure of the purchaser to complete its part of the bargain "prevented it from acquiring the status of a shareholder." The right to dividends was denied.²⁷

784. Stock subscription *v.* underwriting agreement. A stock subscription is an absolute offer to buy stock. An underwriting agreement is "an agreement made before corporate shares are brought before the public, that, in the event of the public's not taking all of the shares or the number mentioned in the agreement, the underwriter will take the shares which the public does not take."²⁸

785. Subscriptions procured through fraud. The rule governing subscription agreements tainted with fraud is no different from the rule governing fraudulent contracts generally, (See sec. 129.) However, the opportunities for abuse in connection with stock prospectuses have led to various state and Federal statutes designed to protect the public against fraudulent representations not always easy to detect and prove. Examples are the Securities Act of 1933 and the Securities Exchange Act of 1934. In some cases, the fraud may lurk in irregular accounting practices. In others the representations may hover between statements of corporate prospects, capabilities and expectations (that are not statements of fact, hence no basis for fraud) and statements of existing fact that, if untrue, do constitute fraud.

Examples:

(1) See Review Question No. 23 on page 448, wherein questionable book entries were made to support a representation that the corporation had a surplus and had legally paid a dividend.

(2) See sec. 1650, illustrating statements of opinion (as to future sales and as to the law), coupled with a statement of fact as to a corporate power contained in a charter.

786. Installment subscriptions. Where a stock subscription is payable in installments, a corporation may sue to recover the unpaid balance of the stock subscription with interest from the date of default, or the corporation may declare the shares and all previous payments thereon forfeited. In the former case, the corporation affirms the subscriber's position as a stockholder; in the latter, it repudiates the subscriber as a

²⁷ *Schwartz v. Manufacturers' Casualty Insurance Company*, 335 Pa. St. Rep. 130, 6 A. 2d 299.

²⁸ *International Products Co. v. Vail's Estate*, 97 Vt. 318, 123 A. 194.

stockholder, and thereafter neither the corporation nor a corporate creditor may hold the subscriber liable as a stockholder.

Required deposit. Statutes in some states provide that stock subscriptions are unenforceable unless accompanied by a minimum down payment. Some corporate charters contain a like provision. The tendency is to dispense with such requirement.²⁹

Paid-in capital. The amount of money or property received by a corporation on its stock subscriptions is known as its paid-in capital.

787. Consideration for which capital stock may be issued. For the protection of creditors and existing stockholders, the law requires that the capital stock of a corporation shall be issued only for equivalent value. To issue capital stock without a corresponding capital contribution is to impair the capital of the corporation.

Original par-value stock cannot be issued except for its full value in cash, property or services.³⁰ National bank stock can be issued only for cash. Once par value stock has been issued, it may be sold for any price the stockholder wishes to accept. If a corporation reacquires any of its issued stock, it may reissue such treasury stock for any price it will fetch.

As to what constitutes full value for original issue stock, the judgment of the directors is final, provided it is honest, and not arbitrary or capricious.

Examples:

(1) You render services connected with the organization of a corporation. At the request of the directors, you accept 100 shares of stock of the corporation, \$100 par, as compensation for your services. The value thus placed on your services will be accepted as final, unless dishonest, arbitrary or capricious conduct on the part of the directors can be shown.

(2) If, in Example (1), the stock had been issued after you had submitted a bill for \$5000 for your services, the validity of the issue, because of the obvious discrepancy, might subsequently be questioned by a judgment creditor of the corporation, though the corporation itself would be bound by the action of its directors. (See sec. 865, subd. (2).)

Original no-par-value stock may be issued for such consideration as represents the fair market value of such shares. As to this, also, the honest judgment of the directors is final. However, such stock must be issued for *some* consideration. Hence, if a new corporation issues no-par value common stock as a bonus with preferred, the transaction is invalid. (See sec. 865, subd. (1).)

Watered stock. Outstanding capital stock, to the extent that it does not represent true value given for it, is said to be diluted or *watered*.

²⁹ The statute in New York, for example, formerly provided that a subscriber to stock of an existing corporation could not be held to his subscription unless at the time of subscribing he had paid at least 10% of the subscription price. The requirement was dropped by amendment in 1924.

³⁰ In some states, directors or stockholders are permitted to fix a price for par value stock at less than par.

Blue sky laws. Laws aimed at preventing the practice of issuing stock for inadequate or fictitious values are known as "blue sky laws." (See sec. 827.)

G. Management: Directors and Officers

788. General scheme of corporate management. Since a corporation is a pure fiction, existing only in contemplation of law, it can act only through agents. The ultimate control of a corporation is in the stockholders, but the actual conduct of a corporation's affairs is delegated by the stockholders to general agents, or *directors*, who guide the general policy of the corporation and who in turn delegate to officers the task of actual management. Finally, to carry out the details of business management, the officers hire the necessary employees.

789. Relationship of directors to corporation. Although the stockholders elect the directors, the directors, once elected, become the representatives of the corporation itself, not of its stockholders.

The official position of a director is one of trust. As to third parties directors are agents; as to the corporation itself they are chargeable as trustees. The judgment of the directors must be unwarpd by personal interest. Any outside consideration received and accepted by them for the discharge of their duties belongs to the corporation. The corporation may not only hold directors liable for breach of their fiduciary duties, but may also hold third parties for inducing directors to breach their duties.

Examples:

(1) Brown, a director of the X Company, received \$500 from the Y Company for inducing the X Company to award a certain contract to the Y Company. The X Company, upon discovering the facts, may recover the sum so paid Brown, or it may sue Brown for breach of his fiduciary duty and the Y Company for inducing such breach.

(2) See sec. 817.

790. Number and qualifications of directors. The law in most states puts no maximum on the number of directors a corporation may have, but prescribes a minimum of at least three.³¹ The Uniform Business Corporation Act provides

³¹ In forty states and territories the minimum number of directors is fixed at three, in Washington the minimum is two, in Tennessee and West Virginia it is five. Thirty-two states put no maximum upon the allowable number of directors, but in fourteen the maximum is fixed at numbers ranging from nine to thirty. In Arizona, Iowa, Rhode Island and Nebraska, the number

that: "The business of every corporation shall be managed by a board of at least three directors." The qualifications of directors vary in the different states. Two common provisions are that all directors must be of full age and that at least one must be a citizen of the United States and a resident of the state. Most states require either that the directors be stockholders or that they be stockholders unless the articles of incorporation or by-laws otherwise provide. Under the Uniform Business Corporation Act the reverse is true: Directors "need not be shareholders unless the articles of incorporation so require."

791. Directors: how chosen. The original board of directors is generally designated in the certificate of incorporation to serve for the first year or until successors are chosen. Frequently, the original directors are dummies; their resignations are accepted and their successors chosen by stockholders' vote at the organization meeting (sec. 767). All directors subsequent to the original board are elected by the stockholders. Such vote in some states (for example, New York) must be by *plurality*; that is, by the largest number of votes cast (as distinguished from a *majority*, which is more than half the votes cast).

Example: A certificate of incorporation provided that directors could not be changed except by unanimous consent of all stockholders. The provision was challenged following an election at which it was attempted to change the directors without such unanimous consent. The court held that the provision was void, because under the state law no larger vote than a plurality could be required for the election of directors.³²

792. Vacancies on board: how filled. As a rule, vacancies on the board of directors are filled by a vote of stockholders at a special meeting called for this purpose or at the next annual meeting following the vacancy. Directors have no power to fill vacancies on their own board except where such power is conferred by statute, charter or by-law. The statute in many states confers such power. The Uniform Business Corporation Act provides that: "Vacancies in the board of directors shall be filled by the remaining members of the board, and each person so elected shall be a director until his successor is

and qualifications of directors are left for determination by the stockholders in the articles of incorporation or by-laws.

³² *In re Boulevard Theater & Realty Company*, 231 N.Y. 615.

elected by the shareholders who may make such election at the next annual meeting of the shareholders, or at any special meeting duly called for that purpose and held prior thereto." In some states the statute provides that vacancies on the board shall be filled as prescribed in the by-laws. Unless a vacancy causes the number of directors to fall below the number required for a quorum, the vacancy does not interfere with the transaction of business and need not be filled until the next annual meeting.

793. Acceptance of office. No corporation can impose the burdens, duties and responsibilities of office upon any person unless he accepts such office.³³

Example: In *Cameron v. Seaman*,³⁴ an action was brought against Seaman to enforce the liability of a trustee for failure properly to file an account. Seaman defended on the ground that he was not present at the meeting of stockholders when he was elected, that he had never received written notification of his election, and that when he was orally notified of his election by the president of the corporation, he had stated he would not serve. On these facts, the Court held that Seaman was not liable, since the facts negated acceptance.

794. Principal duties and powers of directors. Directors function as the original agency by which a corporation expresses its will and achieves its objectives. The principal function of the directors is to establish and guide the policies of the corporation. To accomplish these policies and objectives, the board elects the officers of the corporation, furnishes authority for their major acts and supervises their conduct generally. The board also determines whether to declare dividends, and supervises and approves all major steps and acts initiated and negotiated by the officers.

In the exercise of their duties and powers, directors are guided and limited by the corporation's charter and by-laws and by the governing statutes. Directors have implied power to do what is required for a full discharge of their duties.

Directors have no implied power to be generous with corporate assets, however worthy the objective, unless the expenditure furthers the interests of the corporation.

Example: Directors may vote to increase salaries, but they may not award extra compensation for past services already rendered, since under

³³ *Standard Oil Co. v. Morrison, etc., Co.*, 54 Ill. App. 531.

³⁴ 69 N.Y. 396.

the law the latter would be gratuitous. Bonuses, however, are allowable as an incentive to extra effort.

795. Delegation of duties by directors: executive committees. Directors must attend personally to their duties as directors. Thus, directors may not vote by proxy (sec. 1666, subd. b). However, this relates only to *discretionary* powers; *ministerial* or routine duties may and often are delegated by directors to others³⁵ (sec. 1659).

Example: A stockholders' agreement provided for the election of six equal stockholders as directors, any five of whom might exclude the sixth, upon submission to arbitration. *Held*, that the directors were not required to abide by the terms of the agreement or to resort to arbitration, because their duties could not be thus delegated to others.³⁶

Executive Committee. In the absence of provision to the contrary, the board of directors may delegate its powers to an executive committee, either subject to subsequent board ratification or with full power to act during intervals between board meetings. Executive committees, however, may not "inaugurate radical reversals of or departures from fundamental policies and methods of conducting the business as prescribed by the directorate."³⁷ (See sec. 1659.)

796. Directors must act as board. The authority of directors must be exercised as a body, not individually. Individual directors, unlike individual officers, have no power to act as agents of the corporation.

Examples:

(1) The charter of a banking corporation gave its board of directors power to alter or amend its by-laws. One of the by-laws provided that no interest should be paid on certificates of deposit payable on demand. Such interest was, however, paid to X, whom the bank later sued for return of interest. X proved at the trial that he had obtained, one at a time, the written consent of a majority of the directors to such payment. Proof of such consent was insufficient. Directors must act as a board.

(2) See sec. 1658.

797. Freedom from interference. The law requires directors to exercise their own untrammelled discretion in guiding the affairs of the corporation. General supervision and the actual conduct of a corporation's affairs by its directors and officers respectively, are exclusive; that is, they are not subject to

³⁵ *Wheeler v. Layman Foundation*, 188 Ga. 267, 3 S.E. 2d 645; *Lowell Hoit & Co. v. Detig*, 320 Ill. App. 179, 50 N.E. 2d 602.

³⁶ *In re Allied Fruit & Extract Co.*, 243 App. Div. 52, 276 N.Y.S. 153.

³⁷ *Fensterer v. Pressure Lighting Co.*, 85 Misc. 621, 149 N.Y.S. 49, 53, citing numerous cases.

outside interference.³⁸ Thus, a stockholder owning all the stock of a corporation may not override or interfere with the discretion and control of the board of directors, so long as they hold office. "If the action of the board of directors does not express the will and wish of the majority of the shares of stock, the majority has its remedy by retiring the members . . . at the regular time for election of directors."³⁹ Neither will the courts interfere with the judgment and discretion of directors except for fraud or arbitrary conduct contrary to the interests of the corporation. "As a general rule courts have nothing to do with the internal management of business corporations, but, if the acts of directors are so unjust as to be evidence of fraud and intentional wrong, the courts may act. They may not compel directors to act wisely, but may compel them to act honestly."⁴⁰

Examples:

(1) The controlling stockholders of a corporation agreed to elect certain directors who would act as nominal directors only and who would not take part in the management of the corporation. The Court held such an arrangement illegal. Only directors may direct.⁴¹

(2) A majority stockholder designates his son as treasurer of the corporation. Certain minority stockholders object. Their objection may be enforced by court action. Only directors may elect officers. Stockholders have no right to interfere except through regular corporate action.⁴²

798. Meetings of directors. Formerly, it was the rule rather than the exception that corporations organized in a given state had to hold their directors' as well as their stockholders' meetings within the state. The rule is now the other way. In practically all states, directors may hold their meetings outside the state upon special authorization contained in a statute, charter, by-law, majority vote of directors or, in some cases, by inference from the fact that there is no statutory provision against it.

Conduct of meetings. Directors' meetings need not be conducted by parliamentary rules, but parliamentary usage generally governs. Proposals for action are usually formulated by the chairman, and the order of dispo-

³⁸ *Raynolds v. Diamond Mills Paper Co.*, 69 N.J. Eq. 299, 60 A. 941.

³⁹ *Lamb v. Lehmann*, 110 Ohio St. 59, 143 N.E. 276.

⁴⁰ *Jones v. Van Heusen Charles Co.*, 230 App. Div. 694, 696.

⁴¹ *Jackson v. Hooper*, 76 N.J. Eq. 592.

⁴² *Walsenburg Water Co. v. Moore*, 5 Colo. App. 144, 38 P. 60; *State v. Rosenow*, 174 Wis. 9, 182 N.W. 324. In some states, however, provision may be made for the election of certain officers by the stockholders.

sition thereon is generally as follows: (1) Report, (2) motion, (3) discussion, and (4) resolution. (See sec. 1655.)

Minutes. Directors must see to it that a record of their meetings, known as *minutes*, is kept by an officer of the corporation duly charged with this duty. Such officer is usually the secretary. The minutes should show the dates of all meetings, the members who attended and the resolutions adopted. If the minutes are in any respect inaccurate, the board of directors may correct them so as to show what action was actually taken at the meeting.

799. Compensation of directors. Directors as such are not ordinarily entitled to compensation, unless there is some provision in the charter or by-laws of the corporation for this purpose. However, where a director renders services not as director, but in some other capacity—as, for example, where a director renders legal, accounting or engineering services apart from his duties as director—he is entitled to compensation for such services, because it will be implied, in the absence of express contract, that services of this character are not ordinarily rendered gratuitously.

800. Disqualification by personal interest. A director, as we have seen, stands in a fiduciary relation to the corporation that he serves. He must not permit himself to act on behalf of the corporation if his act is tainted by self-interest. A director is therefore disqualified to vote at a meeting of the board if he has any personal interest in a matter before the board; neither can his vote, in such case, be counted in making up a quorum. If a director does vote on such matter, the vote cannot be counted in determining the action of the board; and if it has been counted and was decisive, the action of the board may be set aside. It is customary for a director who has a personal interest in a matter under consideration by the board to note on the minutes that he is refraining from voting in respect to the matter. Directors who are also officers should refrain from voting on a resolution fixing their own compensation. (See sec. 1656, subd. *a*.)

801. Tenure of office: removal of directors. Generally, when a director is elected for a fixed term, such term, except for cause, cannot be abridged without the director's consent. The tendency of statutes today is to limit the tenure of office so as to require periodic re-election. The Uniform Business

⁴³ Sec. 31.

Corporation Act provides⁴³ that: "Except as otherwise prescribed in the articles or by-laws * * * a director shall be elected for a term of one year." Where long terms are permitted, rotation in office is frequently prescribed. For example, the New York Stock Corporation Law provides⁴⁴ that at least one-fourth of the directors of every stock corporation must be elected annually.

Where the by-laws specifically provide that a director may be removed at any time, with or without cause, such provision has the binding force of a contract and such director may be removed arbitrarily at any time.

802. Holding over. Officers and directors whose terms have expired, hold over until their successors are chosen or until they resign or are removed. This applies not only to directors elected at a meeting of stockholders but also to original directors named in a certificate of incorporation.

803. De facto officers and directors. We have already explained the meaning of "de jure" and "de facto" as applied to corporations. Similarly, a *de jure* officer or director is one duly qualified, and duly elected and functioning as such. A *de facto* officer or director is one holding office with ostensible corporate consent and under color of election or appointment, though such election or appointment be irregular. The irregularity may consist in the manner of election, or in some personal disqualification for office, involving age, citizenship, residence, ownership of stock and the like. If a director thus elected accepts office and acts at a directors' meeting, he is said to be a director *de facto*.

Example: In *Conaty v. Torgben, et al.*,⁴⁵ the only active officer was the secretary, who appointed a president and a treasurer to sign checks as required by the bank. All three were held to be officers *de facto*.

804. Resignation. Since a director holds office until his successor is chosen, it is not always safe for him to assume that his liabilities cease when his term expires. If a director wishes to terminate his duties and liabilities as such, he must tender his resignation. Directors or officers may resign during office or while holding over, despite a provision that they shall serve for a prescribed term and until their successors are chosen.

⁴⁴ Sec. 55.

⁴⁵ 46 R.I. 447.

805. Agreements for perpetuation in office: agreements upon united action. Though continuation in office of experienced directors may be desirable from the business standpoint, it is regarded as against public policy to contrive perpetuation in office by agreement or by dispensing with elections.

Examples:

(1) Three directors controlling a majority of the stock of a corporation made an agreement to vote as stockholders and directors for the election of one another, or of such persons as they should respectively nominate, to the offices of president, treasurer and auditor, respectively, so long as each should remain such stockholder and desire such office. The Court held the agreement illegal.⁴⁶

(2) McQuade, Stoneham and McGraw, as owners of the majority of the stock of the New York National Baseball Club ("Giants"), entered into an agreement for the election of one another as specified officers of the corporation at specified salaries, and to "use their best endeavors" to continue themselves in office as directors and officers. Later, McQuade was dropped. He sued for reinstatement and damages. The Court held that "stockholders may not, by agreement among themselves, control the directors in the exercise of the judgment vested in them by virtue of their office to elect officers and fix salaries. * * * Directors may not by agreements entered into as stockholders abrogate their independent judgment."⁴⁷

(3) See sec. 1657.

Stockholders' agreements upon united action. Although it is contrary to public policy to contrive perpetuation in office, it is not illegal for stockholders to unite upon a common policy or the election of certain directors.⁴⁸

806. Officers: distinguished from directors. Although in the broadest sense directors are "officers" of the corporation, in a narrower sense they are clearly distinguishable from officers. The officers of a corporation, unlike its directors, are true agents of the corporation. Each officer may bind the corporation by his individual acts within the actual or apparent scope of his authority. A director, on the other hand, as previously noted (sec. 796), has no individual authority to act for the corporation.

A director, by virtue of his office as such, cannot legally bind the corporation to a contractual or other obligation (sec. 1653, subd. c).

Example: Bundy is the principal stockholder and a director of the Bundy Corporation, but holds no office in the company. He hires Wilson

⁴⁶ *Snow v. Church*, 13 App. Div. 108, 42 N.Y. Supp. 1072.

⁴⁷ *McQuade v. Stoneham*, 263 N.Y. 323.

⁴⁸ *Manson v. Curtis*, 223 N.Y. 313; *Brightman v. Bates*, 175 Mass. 105, 55 N.E. 809.

as assistant treasurer for the company under a written contract for two years. Wilson, with full knowledge of Bundy's status, accepts the employment. The treasurer repudiates the employment and Wilson sues the company for breach of contract. The corporation will prevail. Wilson had no right to assume that Bundy, as a director, had authority to bind the corporation by contract.

Again, the authority of directors is *original*, not *derivative*. Officers, however, have only such powers as are conferred upon them in the by-laws, subject to charter and statutory limitation. "The board of directors of a corporation do not stand in the same relation to the corporate body which a private agent holds towards his principal. In the strict relation of principal and agent, all the authority of the latter is derived by delegation from the former. * * * But in corporate bodies, the powers of the board of directors are, in a very important sense, original and undelegated. The stockholders do not confer nor can they revoke those powers. They are derivative only in the sense of being received from the state in the act of incorporation. The directors convened as a board are the primary possessors of all the powers which the charter confers. * * * " 49

807. Election of officers: tenure. Officers, as previously noted, are elected by the directors. They are usually elected for a definite term fixed in the by-laws, statute or charter. Where such term is fixed, officers are regarded as having *tenure*, which, like other contracts, cannot be disturbed except for cause. If no term is fixed by statute, charter, by-law or other contract, officers are removable at the pleasure of the directors.

808. Usual corporate officers. The usual officers of a corporation are the president, secretary and treasurer. In addition, convenience and the nature of a corporation's business frequently require the appointment of one or more vice presidents, managing directors, general managers or superintendents, counsel, assistant secretaries, assistant treasurers and auditors. It is not illegal or improper to choose one person for two corporate offices.

809. Duties of officers. The duties of officers are prescribed in the by-laws, and they vary accordingly. Usually, the by-laws provide as follows:

President. The president presides at stockholders' and directors' meetings. As a rule, he must be a director himself. He signs certificates of

⁴⁹ *Hoyt v. Thomson's Executor*, 19 N.Y. 216. See also *Kaplan v. Block*, 183 Va. 327, 31 S.E. 2d 893.

stock, contracts, drafts, checks, promissory notes and similar commitments on behalf of the corporation.

Vice President. The vice president acts in the president's absence, and discharges such other duties as may be designated in the by-laws.

Secretary. The secretary records, signs and keeps the minutes of meetings of stockholders and of directors; attends to giving and serving all notices; affixes the corporate seal to certificates of stock and countersigns such certificates (except where the treasurer is charged with such duty of countersignature); and has charge of the stock book, certificate book and other corporate books, papers, documents and records. He also makes up the necessary tax and other reports required by law.

Treasurer. The treasurer is the chief financial officer of the corporation and the custodian of its funds and other assets. He is frequently designated as the officer to sign or countersign all promissory notes, bills of exchange, checks and other corporate instruments for the payment of money. He is thus both custodian of the corporation's property and paymaster of its debts. He is likewise the collecting officer of the corporation. He is frequently required to give bond for faithful performance. He must see that the corporate books of account and records of financial transactions are accurately kept, so as to reflect the true financial condition of the company.

810. Freedom of officers from interference. Officers, like directors, are immune from interference with the discharge of their duties. They may be removed for cause, or in some cases (sec. 807) without cause, or upon the expiration of their terms; but so long as they function, they cannot be dictated to by directors or stockholders as to contracts to be signed, employees to be hired or any other details of management.

811. Compensation of officers. Officers, more frequently than directors (sec. 799), serve for compensation. Their salaries are fixed by resolution of the board of directors. As noted in sec. 800, directors who are also officers should refrain from voting on a resolution fixing their own compensation.

812. Salaries in lieu of dividends. Where small groups dominate a corporation through stock ownership, it is not uncommon for the dominating stockholders to elect themselves as directors and officers and to vote themselves salaries that should go into surplus available for dividends. Such practice is frequently difficult to combat because of the hesitancy of courts to interfere with the discretion of directors in the internal management of a corporation. However, if salaries are clearly more than a fair and reasonable compensation, or if their payment clearly amounts to bad faith, fraud or a breach

of trust, the Court will require restoration of such salaries to the surplus of the corporation.

813. Transactions with corporation. The rules generally applicable to dealings between principal and agent apply to the relationship between a corporation and its officers and directors. Officers and directors may make contracts with their corporation provided they do so openly and upon full disclosure. If, however, they secretly benefit in their dealings with the corporation, they may be compelled to account for such benefits.

814. Profiting at corporate expense. Directors and officers owe primary allegiance to the corporation that they serve. Hence, if a director or officer, either by competing or by driving a hard bargain with his corporation, derives a profit at the corporation's expense, he must account to the corporation for such profit.

Example: A piano concern was in financial difficulties. A director knew it, and took advantage of his corporation by buying pianos from it at prices that he knew were inadequate. He kept the majority of the board in ignorance of the terms of the contract. For the profits thus derived by the director out of his dealings with the corporation, the Court held the director accountable to the corporation.⁵⁰

815. Taking personal advantage of corporate opportunities. Directors and officers must rigidly refrain from taking advantage of corporate opportunities. Even where the corporation rejects a transaction, directors, though acting ostensibly in good faith and with the best of motives, must not avail themselves of the transaction thus rejected. If they do, they will be open to the suspicion that they rejected the transaction on behalf of the corporation so that they could take advantage of the opportunity themselves.

Example: The Acoustic Products Company dealt in phonographs, radios and similar apparatus. An offer was made to the company to sell it certain shares in the De Forest Radio Co. that would give the Acoustic Company valuable rights of manufacture. The directors of the Acoustic Company rejected the offer on the ground that the company was financially unable to purchase the stock, which was probably the fact. Later, the same directors formed a syndicate, purchased the stock themselves, and made a substantial profit. The Court, holding that fiduciaries should not be permitted to assume a position in which their individual interests might con-

⁵⁰ *Lazenby v. Henderson*, 241 Mass. 177.

flict with those of the corporation, compelled the directors to account to the corporation for these profits.⁵¹

816. Dealings in corporate stock. Directors and officers may purchase stock in their corporation or, if they already own it, may dispose of it in any way they see fit. However, if they use their official position to gain advantage for themselves in connection with the issuance, purchase or sale of such stock, they will be compelled to account to the corporation for any profits thus derived.

Example: The directors and officers of a corporation whose stock is listed on the stock exchange, having advance knowledge of an extra dividend to be declared, purchase a large block of the company's stock. Later, when the dividend is declared and the stock correspondingly advances in price, they sell their stock at a substantial profit. The directors and officers may be compelled to account for such profits. They are further liable under the Securities Exchange Act of 1934.⁵²

817. Dealings in corporate office. Directors and officers have no right to engage in transactions, the object of which is to buy or sell corporate office. Any proceeds thereby derived belong to the corporation.

Example: The directors and president of a life insurance company receive money from an outsider for procuring the election of the outsider and his friends as directors with control and management of the insurance company. Held: that the officers and directors had a right to resign, but that money paid for procuring for others their election as directors and control of the company was derived by virtue of office and therefore belonged to the corporation.⁵³

818. Dual allegiance: interlocking officers and directors. The mere fact that a majority of or even all the directors or contracting officers of two corporations are common to both does not render a contract between such corporations void. The contract is merely voidable (sec. 176) if fraud or unfairness can be shown to have been exercised. However, such transactions are viewed with suspicion by the courts because they place fiduciaries in a position of dual allegiance.⁵⁴

⁵¹ *Irving Trust Company v. Deutsch*, 75 F. (2d) 121.

⁵² Section 16(b).

⁵³ *McChure v. Law*, 161 N.Y. 78, citing *Chandler v. Bacon*, 30 Fed. Rep. 538; *Rutland El. L. Co. v. Bates*, 68 Vt. 579; *Farmers & Merchants' Bank v. Downey*, 53 Cal. 466.

⁵⁴ *Potter v. Sanitary Co. of America*, (Del.), 194 A. 87; *Overfield v. Penn-road Corporation*, D.C. Pa., 42 F. Supp. 586, op. supp. 48 F. Supp. 1008, affd., C.C.A., 146 F. 2d 889; *Godfrey L. Cabot, Inc. v. Gas Products Co.*, 93 Mont. 497, 19 P. 2d 878, 883; *Truman v. Coghlin Machinery & Supply Co.*, 11 Ohio

Example: Maynard was the dominating stockholder and director of an electric company and of a woolen company. He negotiated a contract by which the electric company was required to furnish power to the woolen company at losing rates. The electric company refused to proceed with the contract and the woolen company sued. The Court, in refusing to enforce the contract, held that although Maynard had refrained from voting, it was his duty as a director "to speak out and not reap a profit from the errors of the other directors." He could not "rid himself of the duty to warn and denounce * * * improvidence or oppression * * * visible to his practiced eye." ⁵⁵

819. Liability for negligence. Directors and officers, like agents, are liable to the corporation for loss sustained by it through their negligence in office.

Example: A resolution of the X Corporation provided that all checks were to be signed by the treasurer and countersigned by the president or a director. By a series of ingenious excuses the treasurer, from time to time, obtained countersignatures, by directors, of checks payable to cash or to bearer, then misappropriated the proceeds and disappeared. Upon discovery of the misappropriation, the corporation may require the directors to make good their negligence.

What constitutes negligence is a question of fact in each case.

Liability for misconduct of codirectors. Directors may be negligent not only with respect to the normal discharge of their duties but also for failure to detect and prevent wrongs by codirectors or to redress such wrongs on behalf of the corporation after they were committed. The nonparticipating directors, in such cases, are jointly and severally liable with the participating directors.

820. Liability for nonexistent or defectively organized corporation. Persons who purport to act for a nonexistent corporation are in the same position as agents who purport to act for a nonexistent principal: They are personally liable in such transactions (see sec. 574). A similar rule, as already noted, applies in connection with defectively organized corporations (sec. 752).

821. Liability for preferential transfers. Stockholders and judgment creditors of a corporation may hold directors and officers personally liable to the full extent of any loss sustained if such directors or officers are guilty of preferential transfers.

App. 220; *Bonini v. Family Theatre Corporation*, 327 Pa. 273, 194 A. 498; *Olympia Box & Package Co. v. Pacific Veneer Co.*, 123 Wash. 533, 213 P. 24; *Wheeling Dollar Sav. & Trust Co. v. Hoffman*, (W.Va.), 35 S.E. 2d 84; *State v. Grossman*, 213 Wis. 135, 250 N.W. 832, 833.

⁵⁵ *Globe Woolen Co. v. Utica Gas & Electric Co.*, 224 N.Y. 483.

Examples of preferential transfers:

(1) Transferring corporate property to an officer, director or stockholder in payment of a debt or for any consideration other than full value in cash, where the corporation has previously refused to pay any of its notes or other obligations when due.

(2) Preferring any creditor (except wage earners) over other creditors while the corporation is insolvent.

822. Liability for loans to stockholders, directors and officers. Statutes commonly forbid directors to make loans of corporate funds to stockholders, directors or officers. For example, the New York statute⁵⁶ provides that officers or directors who make or assent to such loans are jointly and severally personally liable to the extent thereof and interest.

823. Liability in connection with treasury stock. Directors incur personal liability if they authorize the acquisition of treasury stock out of capital instead of surplus (sec. 774). Also, in causing a corporation to acquire or dispose of treasury stock, directors must not prejudice the rights of creditors or stockholders. (See sec. 1661.)

824. Liability for declaring dividends out of capital. Directors may declare dividends only out of surplus. If directors pay dividends out of capital instead of surplus, they may incur liability (a) at law to the corporation, (b) in equity to creditors, and (c) criminally, by statute. A statute may exempt directors from liability where (1) they cause their dissent to be noted in the minutes at the time the dividend is declared, or (2) they were absent when the dividend was declared but communicated their dissent in writing within a reasonable time after learning of the dividend declaration (see sec. 831), or (3) they can show they had reasonable ground to believe and did believe that the dividend distribution would not impair capital.

825. Liability for failure to file reports. States commonly impose personal liability on corporate directors or officers for failure to file or publish reports containing prescribed information as to corporate affairs, or for failing to file such reports within a prescribed time. Even more severe penalties are provided by statute for making fraudulent reports. (See sec. 829.)

⁵⁶ Stock Corporation Law, sec. 59.

826. Liability for failure to qualify a foreign corporation. Every state has a right to require foreign corporations doing business in that state to qualify by filing a prescribed certificate and paying a prescribed fee. There are various penalties in the different states for failure to comply with such requirement, the most common of which is to deprive the offending corporation of the right to bring suit on any contracts made in the state. (See sec. 874.) In a number of states, however, such as Massachusetts, Virginia, Florida, Indiana, Colorado, Idaho and Utah, directors, officers, agents or employees acting on behalf of such corporation are made personally liable for obligations incurred by such foreign corporations, and in some cases for fines imposed on the corporation in such situations. (See sec. 875.)

827. Liability in connection with fraudulent practices (blue sky laws). Reference has been made to the so-called "blue sky laws" in connection with the consideration for which capital stock may be issued (sec. 787). Many states have statutes that prescribe penalties for fraudulent corporate practices in connection with the issuance of corporate stocks, bonds, notes or other securities. Any officer, director or employee engaged in or connected with such fraudulent practices is subject to severe penalties.

828. Liability for issuing unauthorized stocks and bonds. Statutes impose heavy penalties on officers for the unauthorized issuance of stocks and bonds. For example, the New York statute provides that any officer or agent of a corporation who wilfully, knowingly and with intent to defraud, sells, pledges, issues, signs or executes any certificate of stock, bond or other evidence of debt without corporate authority, or contrary to the charter or laws under which the corporation exists, or in excess of corporate authority, is punishable by imprisonment for a term not exceeding seven years, or by a fine not exceeding \$3000, or by both. The same statute also provides that an officer or director of a stock corporation is guilty of a misdemeanor punishable by imprisonment for not less than six months or by a fine not exceeding \$5000, or by both, if he issues, participates in issuing or concurs in a vote to issue any increase of capital stock beyond the amount of the capitalization authorized by the charter, or if he sells, agrees to sell or is directly or indirectly interested in selling any share of stock of

such corporation, unless at the time of such sale or agreement to sell, he is an actual owner of such share of stock.

829. Criminal misconduct in connection with corporate books and records. Penal statutes generally impose fines or imprisonment for misconduct of directors, officers or employees in connection with corporate books and records. For example, the New York statute⁵⁷ provides that a director, officer, agent or employee of a corporation is guilty of a misdemeanor if, in connection with corporate books and records, he knowingly makes false entries, omits material ones, publishes false financial statements, suppresses injunction papers served upon him, refuses or neglects to make official reports or statements required by law, or causes or concurs in any of these acts or omissions. (See sec. 46.)

830. Liability for political contributions. Statutes generally prohibit political contributions by a corporation except where the corporation is organized for political purposes. Directors and officers who participate in, aid, abet, advise or consent to such violation are guilty of a misdemeanor and are subject to such penalties as the particular statutes of a state may impose.

831. Innocent directors: steps for protection against liability. When a majority of the board of directors adopts a resolution that an innocent director believes to be wrong, he should see that his dissent from the resolution is noted in the minutes. Even where a director is absent from the meeting, it is not safe for him to assume that such absence protects him against liability, because while this may be true in many cases, there are some cases where the statute requires such director to put himself on record notwithstanding his absence. For example, the New York statute provides that where dividends are declared out of capital instead of surplus, a director absent from the meeting at which such action was taken, if he wishes to relieve himself from liability for such act, must communicate his dissent to the secretary of the corporation or cause his dissent to be entered on the minutes within a reasonable time after he learns of the dividend declaration.

H. Rights of Stockholders

832. Who are stockholders. Not all persons registered on the books of a corporation are stockholders. One may hold

⁵⁷ Penal Law, sec. 665.

stock in the name of a nominee, trustee or other fiduciary, so that an examination of the stock ledger will not necessarily indicate the true owners of the shares. A stockholder is one who is recognized as the true owner of stock, either at law, as where the stock is directly held, or in equity, as where the stock is held by one person for the benefit of another.

Three ways of acquiring stock. A person may become a stockholder (1) by original issue, (2) by the purchase of treasury stock, and (3) by stock transfer from an existing stockholder.

833. When stockholder's rights arise. One acquires the rights of a stockholder as soon as he becomes the true owner of the stock, either in law or in equity.

Original issue stock. In the case of a *present subscription*, as we have noted (sec. 783), one becomes a stockholder when his subscription is accepted, regardless of whether the certificate has been issued or the price paid; whereas in case of a *contract to purchase* stock one does not become a stockholder until discharge of the concurrent conditions of (1) payment and (2) delivery of the certificate.

Treasury stock. Same rule as with original issue stock.

Stock transfers. In the case of stock transfers *as between the old and the new stockholder*, the latter acquires the rights of a stockholder as soon as he buys the stock. As between the *corporation and the new stockholder*, the latter is not recognized as a stockholder until the transfer is registered on the corporate books.

Example: Ladd on June 4 sells stock to Brown, who has the transfer registered on the books of the corporation June 6. The corporation, having declared a dividend to holders of record June 5, pays Ladd the dividend. Brown has a claim against Ladd, not against the corporation.

834. Rights and privileges of stockholder. The more common rights and privileges of a stockholder are: (1) The right to a certificate, (2) the right to transfer the stock, (3) the right to vote, (4) the right to dividends, (5) the right to inspect corporate books, (6) the "pre-emptive" right, and (7) the right upon dissolution to a proportionate share of the net assets. These rights are briefly discussed in the sections that follow (835-861).

835. Right to certificate; lost certificates. A stockholder has the right to a duly authenticated certificate evidencing his stock ownership. If the certificate is lost, stolen or destroyed, the stockholder may compel the corporation to issue a new one upon filing a bond indemnifying the corporation against liability should the old certificate turn up in the hands of an inno-

cent holder for value. Ordinarily, a corporation will issue a new certificate upon an affidavit setting forth the facts in full, accompanied by an indemnity bond. Where the corporation refuses to issue a new certificate in such cases, a court order may be obtained to compel its issuance.

836. Right to transfer stock. The right to transfer stock is as important as the right to own it. Stock may be transferred in three ways: (1) By delivering the certificate, duly indorsed on the back; (2) by delivering the certificate accompanied by a separate assignment; and (3) where stock is levied on in execution of a judgment, by delivering the certificate coupled with an assignment by the sheriff or marshal who made the levy. (See sec. 1664.) Stock transfers are governed by the Uniform Stock Transfer Act.

Registration of transfer. To register a transfer on the books of the corporation, the purchaser presents his duly indorsed certificate to the secretary or assistant secretary of the company, or to a transfer agent where the corporation has one. Such corporate officer or agent, to safeguard the corporation, (1) checks the certificate for proper indorsement, (2) verifies the transferor's signature, (3) checks authority and authenticity where the indorsement is by power of attorney, trustee, guardian, executor, administrator or other fiduciary, and requires proof of such authority in case of doubt, (4) sees that the proper tax stamps are affixed, and (5) checks the old certificate with the stock list or ledger. If all is in order, he cancels and files the old certificate, issues a new one, and registers the transfer.

837. Limitations upon right to transfer stock. Although the right to transfer stock is implicit in the right to own it, the law permits reasonable restrictions upon the right. Such restrictions may be imposed by charter, by-law or special contract. Since an innocent purchaser of stock is not bound by such restrictions unless he has notice of them, it is customary to indorse such notice on the stock certificates. Usually, the restrictions concern (a) unpaid stock or (b) a requirement that the stockholder must not sell the stock to outsiders without first offering it to the corporation or existing stockholders on specified terms.

(a) *Unpaid stock: lien.* In the absence of restriction, a stockholder may freely transfer his stock regardless of unpaid installments. The Uniform Stock Transfer Act provides that a corporation has no lien upon stock nor any right to restrict its transfer, unless such lien or right is noted upon the certificate. A corporation, by charter or by-law provision, may reserve the right to refuse to register a stock transfer unless the stock is fully paid.

If, notwithstanding such right, the corporation registers the transfer though the stock has not been fully paid, the right to hold the transferor is waived (sec. 865, subd. (3)).

(b) *Pre-emptive options.* Closed corporations frequently provide, by charter, by-law or separate agreement among the stockholders and with the corporation, that no stockholder shall offer his stock to outsiders without first offering it to the corporation or existing stockholders on specified terms. A by-law containing such provision has the force of a contract and cannot be subsequently changed without the consent of all parties concerned.⁵⁸

Example: Three incorporators adopted a by-law providing that no stockholder could sell his stock without first offering it for sale to the corporation at the proposed sales price. Twelve years later a majority of the stockholders adopted a resolution repealing the by-law. Plaintiff, a stockholder, was granted an injunction restraining the amendment on the ground that the by-law constituted a valid contract that could not be repealed without the consent of all.⁵⁹

838. Right to vote: nature of. A vote is a means of ascertaining the will of a group. The voting rights of stockholders have already been referred to in the discussion of common and preferred stock (secs. 776-777). The right to vote is governed and determined by (1) the charter, (2) the by-laws, and (3) the controlling statutes.

839. Right to vote as governed by charter. The charter of a corporation usually designates and prescribes the voting privileges of the different classes of stock. If the charter is silent on the subject, preferred and common stockholders have an equal right to vote. Usually, however, the charter provides that only common stockholders shall vote. Often there is a provision that if dividends on the preferred are "passed," the preferred stockholders may take over control until their rights are satisfied. Under the common law, each stockholder, regardless of the number of shares he held, was entitled to but one vote. Today, each stockholder is entitled to one vote for each share held.

Cumulative voting. Frequently the charter provides for cumulative voting as a device to insure minority representation on the board of directors. By ordinary voting, a stockholder must vote for an entire slate, not

⁵⁸ *Warner & Swasey Co. v. Rusterholz*, D.C. Minn., 41 F. Supp. 498; *People v. Galskis*, 233 Ill. App. 414; *Doss v. Yingling*, 95 Ind. App. 494, 172 N.E. 801; *U.S. Gypsum Co. v. Houston*, 239 Mich. 249, 214 N.W. 197; *In re Magnetic Mfg. Co.*, 201 Wis. 154, 229 N.W. 544; *Hulse v. Consolidated Quicksilver Mining Corp.*, 65 Idaho 768, 154 P. 2d 149, 153.

⁵⁹ *Cowles v. Cowles Realty Co.*, 201 App. Div. 460, 194 N.Y. Supp. 546.

for individual directors; that is, he votes for a proposed board of directors as a unit. By cumulative voting, a stockholder may concentrate his voting strength on one or more directors to be elected, instead of spreading his vote over the entire slate. (For an example, see sec. 1666.)

840. Right to vote: by-law provisions. The by-laws may require that certain corporate acts shall be invalid unless authorized or approved by the stockholders. In such cases, stockholders' approval is required, though not necessarily at a meeting (as in the case of a vote by directors).

Example: The by-laws of a corporation provided that approval by 60% of the stockholders was necessary for a sale of capital assets or the purchase of treasury stock. The president, owning one-half of the company's stock, conveyed, on its behalf, a substantial part of its real property in exchange for the rest of the outstanding stock. Such sale of a capital asset and such acquisition of treasury stock were entirely valid, since the transaction was participated in, hence approved by all the stockholders.

841. Right to vote as governed by statute. No charter or by-law provision may conflict with an existing statute governing a stockholder's right to vote. If it does, the provision is invalid. The law provides that certain basic powers of a corporation must be exercised by the stockholders themselves, instead of through directors and officers. The New York statute, for example, provides that the following corporate acts must be determined by the indicated vote of stockholders:

<i>Acts</i>	<i>Vote</i>
Election of directors	Plurality
Increase or reduction of capital stock	Majority
Change in place of business	Majority
Change in <i>number</i> of directors	Majority
Extend corporate existence	Majority
Mortgage corporate property	Two-thirds
Consolidate	Two-thirds
Sell entire corporate assets	Two-thirds
Dissolve corporation	Two-thirds

However, where stockholders have failed to approve a transaction as required by statute, but have retained the benefits of the transaction, they cannot subsequently question its validity.

Example: A mortgage on corporate realty was executed and delivered in the name and on behalf of the corporation by its president and secretary, without further authority. The company received adequate value for the mortgage and retained it. If the stockholders knew and acquiesced in the transaction, they would be estopped to question it, otherwise not.

842. Stockholders' meetings. Meetings of stockholders may be *regular* or *special*. The annual meeting of stockholders, as fixed in the by-laws, is a regular meeting. A meeting called to vote on some special project is a special meeting. The *minutes*, or the record of the meetings, must be kept in a Minute Book. All stockholders entitled to vote are entitled to a notice of the meetings. This notice must specify the purpose or purposes of the meeting. Meetings must be held at the time and place, if any, fixed by the charter or by-laws, or at any reasonable place (usually required to be within the state of incorporation). However, stockholders may sign a *waiver of notice of meeting*, and this is the usual practice with small corporations, to avoid the trouble of sending out notices of meeting.

843. Quorum. A quorum is the number of votes necessary to validate a meeting. The charter or by-laws of a corporation may fix the number of shares necessary to constitute a quorum, but such provision must not conflict with the law.

Example: If the statute provides (as it does in some states) that in the election of directors a stockholders' quorum cannot be fixed at more than a majority, a charter or by-law provision fixing a quorum at two-thirds would be invalid.

The Uniform Business Corporation Act provides that a majority constitutes a quorum *unless otherwise provided in the articles of incorporation*.

844. Proxies. A proxy is a power of attorney (sec. 550) given by a stockholder authorizing a designated person to cast the stockholder's ballot. Like any other agency, a proxy may be revoked at any time unless "coupled with an interest" (sec. 581). Statutes may limit the duration of a proxy.⁶⁰ One need not be a stockholder to be a proxy. The authority of a proxy generally is discretionary rather than ministerial (i.e., routine); hence a proxy, unless so authorized, may not appoint another in his place (sec. 1666, subd. d).

845. Voting trusts. A voting trust is an agreement by which stockholders surrender their voting power and place it irrevocably in the hands of others. Such agreements, in that they vest voting power in the hands of persons having no beneficial interest in the stock, are generally restricted as contrary to public policy. For example, statutes commonly provide that

⁶⁰ In New York, for example, the General Corporation Law (sec. 19) provides that a proxy expires after eleven months unless its duration is specified.

a voting trust agreement is void unless it is limited to a period of ten years.⁶¹ In exchange for the certificates of stock deposited with the voting trustees, the latter issue *voting trust certificates*.

846. Minority stockholders. Although minority stockholders must abide by the decision of the majority, they may restrain the majority from exercising control (1) to the detriment of the corporation, or (2) for the sole benefit of the majority, or (3) in violation of the charter, by-laws or statute.

Examples:

(1) A proposal by the majority to transfer valuable corporate assets to a "friendly" competitor, thereby crippling the corporation, may be restrained by the minority.

(2) If a majority seeks to absorb as salaries profits that should go into dividends, a court will overcome its hesitancy in interfering with the judgment of directors and will intervene to provide redress at the instance of a minority stockholder. (See sec. 812.)

(3) If three individuals, constituting all the stockholders of a corporation, unanimously adopt a by-law that no stockholder may dispose of his shares without first offering them to the company, any subsequent attempt by a majority of the stockholders to repeal such by-law may be thwarted by a single minority stockholder. (See sec. 837, subd. (b), Example.)

847. Minority stockholders' suits. Wrongs to a corporation should be redressed by the corporation itself acting through its directors. Such directors are supposed to reflect the will of the majority as to what is best for the corporation. However, the majority often act for their own benefit and to the detriment of the corporation itself. In such cases a minority stockholder, after first making a demand upon the directors that they bring suit and following their failure to do so, may himself institute suit on behalf of the corporation. Such an action is said to be "derivative" because the stockholder has no *individual* right of action against directors for neglect and mismanagement entailing loss to the corporation. The right of action is in the corporation, which sustains the loss. Hence, when a stockholder brings a "derivative action," he should do so in the name and on behalf of the corporation. The relief usually sought in minority stockholders' suits is to compel directors and officers to account to the corporation for loss because of their negli-

⁶¹ This is the provision of the Uniform Business Corporation Act, and of the New York and other statutes.

gence, breach of fiduciary duty or other misconduct, and for injunctions to restrain threatened or continued wrongs to the corporation. (See sec. 1662.)

848. Right to dividends: nature and classification. A dividend, literally, is a fund to be divided. A dividend on stock is a distribution of profits to stockholders in proportion to their holdings. Dividends may be either *regular* or *extra*, depending upon the regularity with which they are paid, and either *profit* or *liquidation* dividends, the former payable out of profits, the latter out of capital upon liquidation or dissolution.

Included in the latter category are dividends paid by a trustee in bankruptcy. These differ from dividends paid by a corporation in at least three respects:

(1) A corporation can pay dividends only out of surplus. A trustee in bankruptcy pays dividends out of the corpus or assets in the estate.

(2) Corporate dividends are declared by the directors and paid by a corporate officer. Dividends in bankruptcy are declared by the referee and paid by the trustee.

(3) Corporate dividends represent profits. Dividends by a trustee in bankruptcy do not.

Dividends may also be classified as to the medium in which they are payable, viz., cash, stock or property. The latter are usually payable in securities, though they may also be payable in merchandise; for example, a dividend by a distilling corporation payable in whiskey. Dividends may also be payable in *scrip*, i.e., certificates entitling the holder to cash, stock, bonds or other property. (See sec. 1673, subd. (b).)

849. Stock dividends. A stock dividend is a dividend payable in stock instead of in cash or property. As in the case of all dividends, it cannot be declared except out of surplus. For tax purposes, stock dividends are treated as capital, not as income.⁶² As the United States Supreme Court has pointed out,⁶³ a stock dividend merely transfers an accumulated surplus to the capital account of the corporation. This takes nothing from the property of the corporation and adds nothing to the shareholder. The stockholder receives nothing out of the company's assets for his separate use and benefit, but on the contrary, his investment in the corporation, plus accretions

⁶² *Equitable Trust Co. of New York v. Prentice*, 250 N.Y. 1; *Eisner v. Macomber*, 252 U.S. 189.

⁶³ *Eisner v. Macomber*, *supra*.

and accumulations, remains the same as it was and continues to be the property of the corporation.⁶⁴

The law discourages revaluation of capital assets for the sole purpose of creating an artificial surplus as a basis for stock dividends. (See sec. 1675.)

850. Right to dividends: necessity of declaration. Except where dividends are guaranteed, a stockholder has no inherent right to a dividend unless and until it is declared. The declaration of a dividend rests in the sound discretion of the directors (sec. 853).

Examples:

(1) If a corporation never achieves a surplus, its stockholders never acquire the right to a dividend.

(2) If a corporation declares regular annual dividends in January, the treasurer need not set them up as a liability in his balance sheet as of the previous December 31st. Dividends are not a liability until they are declared.

What constitutes declaration. Dividends need not be declared by formal resolution; any action by the directors indicating an intent to distribute profits will support a dividend payment.⁶⁵ "A formal resolution is not the only evidence of corporate action. * * * Everything that was said and done, the entire setting of the occasion, may help in determining the authorization intended to be conferred and the purpose to be carried out and effected."⁶⁶

Thus, a transfer from surplus to capital, in conjunction with other acts taken at a stockholders' meeting, might constitute the equivalent of a dividend declaration, especially where such disposition is by unanimous consent. (See sec. 1674.)

851. Rights where dividend declared: debt *v.* trust. Whether a dividend, once declared, constitutes a debt or a trust, depends upon whether a fund has been set aside out of which the dividend is to be paid. If no such fund has been set aside, the dividend represents a mere debt. Stockholders in such case share as general creditors (sec. 1332) where bankruptcy intervenes between dividend declaration and dividend payment. On the other hand, if a fund has been set aside out of which the dividend is to be paid, such fund becomes a trust that, in case of bankruptcy, would be beyond the reach of general creditors of the corporation. (See secs. 1671 and 1218.)

⁶⁴ The doctrine has been limited, however, to dividends declared in stock of the same class. *Helvering v. Sprouse*, 318 U.S. 604.

⁶⁵ *Paramount-Richards Theatres v. C.I.R.*, (D.C.), C.C.A. La., 153 F. 2d 602; *Metropolitan Trust Co. v. Becklenberg*, 300 Ill. App. 453, 21 N.E. 2d 152.

⁶⁶ *In re Norton's Will*, 129 Misc. 875, 224 N.Y. Supp. 77, 87-88.

Interest on dividends. As a rule, a stockholder is not entitled to interest on a dividend except where payment is refused after the dividend becomes due.

852. Dividends payable only out of surplus. As previously noted (sec. 824), dividends are payable only out of surplus, that is, out of an excess of assets over liabilities including capital stock.

Example: A corporation has a deficit of \$40,000 as of January 1. During the ensuing year it earns a net income of \$45,000. During the following year the directors declare a dividend of \$10,000 out of the previous year's profits. Such dividend would be illegal.

Borrowing money to pay dividend. It is not necessary, for the payment of a dividend, that the corporate surplus be in cash. If funds on hand are insufficient to pay a cash dividend, the corporation may borrow money for such purpose.

Example: A realty corporation issues \$300,000 worth of stock for an equal amount of cash, with which it buys a building. The building is resold for \$350,000, which is promptly reinvested in another building. There are no corporate liabilities except outstanding stock. The corporation may declare a \$50,000 dividend payable in new stock, scrip, or cash, and in the latter case may borrow money with which to pay the dividend.

It is regarded as unsound business practice to borrow money for the purpose of paying a dividend.⁶⁷

Recovering dividends paid out of capital. Dividends paid out of capital may be recovered by the corporation. If the directors fail to take steps for such recovery after demand by a stockholder that they do so, the stockholder may institute suit for such purpose in the name and on behalf of the corporation or he may sue in the corporate name to hold the directors accountable for loss entailed by the illegal dividend declaration. Similar steps may be instituted by a judgment creditor of the corporation, acting through a receiver, or by a trustee in bankruptcy, to require restitution of the moneys illegally paid.

Dividends paid out of capital may be followed into the hands of stockholders to the extent necessary to pay the debts of the corporation. The fact that directors are liable in such a case does not exonerate the stockholders from liability. (See sec. 865, *Liability for unlawful dividends*.)

853. Discretion of directors in declaring dividends. The determination as to whether dividends should be declared is left to the discretion of the directors. As previously shown (sec. 777), directors may even pass a dividend on noncumulative preferred, though enough is earned for payment of such dividend, if in their discretion they deem such action to be in the interests of the corporation. The discretionary nature of a

⁶⁷ The practice is prohibited in one or two states.

director's duties is nowhere better illustrated than in the matter of weighing the factors involved in a dividend declaration.

Example: You are elected director of a corporation that has issued 6% preferred stock and also common stock. You are required to vote on a resolution to declare a dividend on the common. In the exercise of sound discretion as a director it would be necessary for you to weigh the following factors:

(1) Whether the preferred stock was cumulative or noncumulative. (In the former case, no dividends on common could be declared unless all dividends in arrears on the preferred were first paid.)

(2) If the preferred stock is noncumulative, it would be necessary to declare a 6% dividend on the preferred for the current year before declaring a dividend on the common.

(3) If the certificate of incorporation is silent on whether the preferred is cumulative or noncumulative, dividends (in most states) will be deemed cumulative (sec. 871), though in a number of states this is not the law, and directors should be advised by counsel in the matter.

(4) Whether the preferred stock is participating or nonparticipating (sec. 777).

(5) Whether, after payment of dividends on the preferred, there is a sufficient surplus to justify payment of a dividend on the common.

854. When stockholders may compel dividend. Ordinarily, stockholders may not compel directors to declare a dividend, though the corporation has a substantial surplus. Courts prefer to leave such matters to the judgment of the directors. However, if a stockholder can show that directors, in withholding dividends, are guilty of dishonesty or abuse of discretion, a court of equity will interfere to compel the directors to declare a dividend.

Examples:

(1) The *AB Corporation* made profits sufficient for a 5% dividend on its stock, but the directors refused to declare a dividend. A suit by stockholders to compel the directors to declare a dividend would be dismissed unless fraud, bad faith or arbitrary conduct could be shown.

(2) *K, L, and M* each own one-third of the capital stock of a corporation. All share equally in the profits over a period of years. Subsequently, *L* and *M* together vote *K* out as director and adopt a resolution paying themselves, as salaries, the profits of the corporation. The Court will intervene at *K*'s instance to compel a redistribution of the profits as dividends.⁶⁸

(3) *Ford Motor Co.* had:

A surplus of.....	\$112,000,000
Annual profits of.....	60,000,000
Total liabilities not exceeding.....	20,000,000
Cash available for dividends of.....	54,000,000
But paid, in dividends, only.....	1,200,000

⁶⁸ *Carr v. Kimball*, 153 App. Div. 825, aff'd 215 N.Y. 634.

A court of equity ordered the directors to pay an additional dividend of \$19,000,000, saying: "A business corporation is organized and carried on primarily for the profit of the stockholders."⁶⁹

855. Dividends on partly paid stock. As we have seen (sec. 833), one is entitled to the rights of a stockholder (including the right to dividends) as soon as he becomes a stockholder, which, on a *present subscription* (sec. 783), means as soon as the subscription is *accepted*, whether or not the certificate has been issued or the price paid. To this rule there are two exceptions:

(1) Dividends may be made payable to stockholders *of record* on a given date, and a corporation may refuse to recognize a stockholder as of record until his stock is fully paid.

(2) State statutes⁷⁰ may permit a corporation to provide in its charter that dividends on stock that is payable in installments shall be paid only in proportion to the amount actually paid in on the stock.

Example: X subscribed to an increase in the capital stock of the Monom Company and eventually paid in 40% of the contracted amount, meeting all installment calls promptly as made. The Monom Company soon thereafter declared a 6% dividend. In the absence of a contrary provision, X is entitled to a dividend as a stockholder. However, the dividend may be made payable to stockholders of record on a given date, and the corporation may refuse to recognize a person as a stockholder of record until his stock has been fully paid. Also, the charter may authorize dividend payments in proportion to the amounts actually paid in.

856. Steps in payment of dividends. The usual steps in the payment of dividends are: (1) Report to directors on the financial condition of the company, as a basis for deciding whether dividends should be declared;⁷¹ (2) meeting of directors to consider the advisability of a dividend declaration; (3) adoption of a resolution declaring a dividend payable to stockholders of record on a given date; (4) announcement of the dividend declaration, and notice to stockholders; and (5) payment by the treasurer or fiscal agent to stockholders of record on the date specified. (See sec. 1669, subd. (c).)

857. Revocation of dividends. A declared dividend may be revoked by directors in the following circumstances: (1) When it is illegal or *ultra vires*; (2) when, though lawful and regular, it has not yet been transferred to the account of the stockholder; (3) when it is payable at a future time and the declaration has not been made public nor communicated to the

⁶⁹ *Dodge v. Ford Motor Co.*, 204 Mich. 459.

⁷⁰ For example, sec. 74 of the New York Stock Corporation Law.

⁷¹ Such report is frequently made at the directors' meeting.

stockholders; and (4) when it is a stock dividend and has not yet been issued.⁷²

858. Right to inspect books. A stockholder's right to inspect corporate books is two-fold: (1) The common law right to inspect books of account, and (2) the statutory right to inspect the stock book of the corporation. In some states, the common law right to inspect books of account has been confirmed by statute. In most states, the statutory right of inspection is limited to an examination of the stock book of the company showing names, addresses and stock holdings.

Books of account. The right of a stockholder to inspect the financial books of his corporation is similar to the right of a partner to inspect the books of account of his firm. However, stockholders are relatively more numerous than partners, their interests are frequently relatively slight, and their stock ownership creates no such fiduciary rights and duties as those involved in partnerships. Hence, applications by stockholders to inspect corporate books of account are less readily granted by the courts than in the case of similar applications by partners. Where such inspection is granted, a stockholder may call in the assistance of a public accountant. (See secs. 1679 and 1677, subd. b.) A stockholder's motive in seeking this type of inspection may be questioned. If the inspection is sought for speculative purposes, or for purposes hostile to the interests of the corporation, or to gratify idle curiosity, it will be denied.

Statutory right to inspect stock book. In this type of inspection, motive is generally immaterial. The statute, however, may impose certain limitations. For example, in New York, inspection is limited to (1) persons who have been stockholders for at least six months (regardless of amount of stock held) or (2) persons who hold at least five per cent of the outstanding stock (regardless of how long the stock has been held). For this purpose the stock book must be open daily for at least three hours. Inspection may be denied if sought for the purpose of providing a stockholder's list for commercial exploitation.

Inspection by judgment creditors. Judgment creditors as well as stockholders have a right in most states to inspect the books of account as well as the stock book for the purpose of enforcing judgments obtained against the corporation.

Remedies and penalties for failure to permit inspection. Upon refusal to permit inspection, stockholders may obtain a court order compelling inspection, in addition to fines against the officers concerned.

859. Right to financial statements. Corporate practice in furnishing reports and other information to stockholders varies widely. Many corporations are required to file annual and other reports with state and Federal departments and regula-

⁷² 18 *Corpus Juris Secundum* 1115-1116.

tory commissions. The duty to furnish financial statements to stockholders is not generally prescribed by statute. In some cases, stockholders owning a given percentage of stock are entitled by law to financial statements. In New York, for example, stockholders owning three per cent of the outstanding shares may require the treasurer to furnish a statement of assets and liabilities.⁷³

860. Pre-emptive right. A stockholder's pre-emptive right is his right to subscribe to new stock in proportion to his existing holdings, before such stock is offered to the public. By "new" stock, is meant *newly authorized stock*, not unissued stock under an existing authorization. A corporation need not offer the new issue to existing holders at par, but may demand more, if it can get more from the public.

Examples:

(1) The A Corporation, with an authorized capital stock of \$25,000 (of which \$20,000 is issued and outstanding), is about to sell the rest of its authorized stock to A at par. C, an existing stockholder, demands the right to subscribe to this stock at par in proportion to his present holdings.

(2) Later, the authorized capitalization is increased by \$25,000, which is offered to F at \$150 per share. C demands the right to subscribe to this new stock at par in proportion to his existing stock ownership.

C will not succeed in either of the above situations. However, in (2) above, C will be allowed to subscribe to the new stock at \$150 in proportion to his existing holdings.

Treasury stock. The pre-emptive right does not generally attach to the sale of treasury stock.⁷⁴ Directors, however, may not issue such stock so as to obtain any undue advantage for themselves.⁷⁵ In some states, the reissue of treasury stock is regarded as equivalent to an issue of new stock and is subject to the pre-emptive right.

Preferred stockholders, as a rule, have no pre-emptive rights: so long as their dividends are paid and net assets are equal in value to the amount of outstanding preferred, such stockholders cannot complain.

861. Rights on dissolution. Upon dissolution of a corporation, stockholders are entitled to a *pro rata* distribution of net assets after payment of debts. The order of distribution may be in accordance with priorities fixed in the charter, as where it specifies that preferred creditors shall come first, then Class

⁷³ *Stock Corporation Law*, sec. 77.

⁷⁴ *Crosby v. Stratton*, 17 Colo. App. 212, 68 P. 130; *Thurmond v. Paragon Colliery Co.*, 82 W.Va. 49, 95 S.E. 816.

⁷⁵ *Hammer v. Werner*, 239 App. Div. 38, 265 N.Y. Supp. 172.

“A” stockholders, then Class “B,” and so on. (See “Preference as to Assets on Dissolution,” sec. 777.)

862. Rights where stock is pledged. When a stockholder pledges his stock, the rights of pledgor and pledgee as between themselves may be determined by the terms of the pledge, but such terms are not necessarily binding upon the corporation. Of principal concern to the pledgor and pledgee are (a) the right to dividends, and (b) the right to vote.

(a) *Right to dividends.* The pledgee of stock ordinarily has the right and duty to collect any cash or stock dividends accruing during the pledge and to apply them to the indebtedness, regardless of whether the transfer has been registered on the books of the corporation. However, the corporation is liable to the pledgee for such dividends only if it has notice of his interest.⁷⁶

(b) *Right to vote.* Until title to the stock is perfected in the pledgee and the stock transferred on the corporate books, the pledgor generally retains voting power.⁷⁷

I. Liabilities of Stockholders

863. Commencement and termination of stockholder's liability. As we have seen (sec. 783), a stockholder's liabilities, like his rights and privileges, come into existence when he becomes a stockholder. *So far as the corporation is concerned*, just as a stockholder's rights may not be recognized unless he is a stockholder of record, so his liabilities continue though he has transferred his stock and is no longer actually a stockholder at the time such liabilities arise, provided the transfer has not been recorded on the books of the corporation. This is particularly true of banking corporations.

Example: John Doe transferred 200 shares of stock in the X bank to Richard Roe, with privilege in the latter to return the stock if unable to sell it within six months. Richard Roe signed a blank transfer with power of attorney on the back of the certificate, and two months later returned the certificate to Doe, who pledged it with another bank to secure a loan. Later, the X bank became insolvent. Roe had registered his stock upon acquiring it from Doe, but had neglected to register the retransfer to Doe. The receiver sued Roe on his “double liability.” The Court, holding that Roe should have seen that the retransfer was registered if he wished to avoid his statutory liability as a stockholder, said: “Had a dividend been declared * * * defendant would have been the one entitled to it * * *. Defendant was clothed with title to the advantages, and in the absence of

⁷⁶ 18 *Corpus Juris Secundum* 1117.

⁷⁷ 18 *Corpus Juris Secundum* 1244.

reasonable diligence to effect a transfer upon the bank records, should not be heard to repudiate the disadvantages.”⁷⁸

Where, however, failure to register is the fault of the corporation or of the transferee, a stockholder who has made a bona fide sale of his stock and has done everything in his power to comply with all the requirements ceases to be liable as such.⁷⁹

Where liability has accrued prior to transfer: statute of limitations. Once corporate liability arises, a stockholder cannot escape liability merely by transferring his stock. However, the statute protects him in such cases by fixing a period of limitations. For example, the New York statute⁸⁰ provides that: “No stockholder shall be personally liable for any debt of the corporation not payable within two years from the time it is contracted, nor unless an action for its collection shall be brought against the corporation within two years after the debt becomes due; and no action shall be brought against a stockholder after he shall have ceased to be a stockholder, for any debt of the corporation, unless brought within two years from the time he shall have ceased to be a stockholder.”

864. Limited liability of stockholders. A stockholder's liability is ordinarily limited to the amount of his investment. However, under certain conditions, a stockholder may become specially liable (1) to the corporation, (2) to judgment creditors of the corporation, (3) to wage earners, and (4) to the state.

865. Liability of stockholder to corporation. As pointed out in sec. 786, a stockholder is liable to the corporation for the unpaid balance of his stock subscription with interest from the date of default. Stock may be and frequently is issued on a part-payment basis subject to “call.” When the call is made, payment must be forthcoming or the corporation may exercise its option to sue for the balance or declare a forfeiture of the stock.

On original par value stock issued for less than its full par value, a stockholder is liable to the corporation for the difference.

On original no par value stock, a stockholder is liable to the corporation for the difference between the amount paid in and the agreed price, which must be its fair market value (sec. 787). If the consideration to be paid

⁷⁸ *Broderick v. Pomerantz*, 148 Misc. 188, 265 N.Y. Supp. 425, 427-8.

⁷⁹ *Realty & Rebuilding Co. v. Rea*, 184 Cal. 565, 194 P. 1024; *Andrew v. Sandford*, 212 Iowa 300, 233 N.W. 529, 532; *Schmitt v. Kulamer*, 267 Pa. 1, 110 A. 169.

⁸⁰ Stock Corporation Law, sec. 73.

for such stock is fixed in the articles of incorporation, the subscriber is liable up to this amount.

However, any one of three factors, (1) illegality, (2) estoppel, or (3) waiver, may bar a corporation from recovering against a stockholder in connection with a stock purchase.

(1) *Illegality*. A corporation, including a receiver suing on its behalf, may be barred by illegality from recovering against a stockholder on an unpaid stock subscription.⁸¹

Example: In *Stone v. Young*,⁸² two hundred shares of preferred stock, par \$100, were issued at a price \$20,000, with one hundred shares of no-par common thrown in. After the subscriber paid in \$13,000, the corporation became insolvent. A receiver sued for the unpaid balance of \$7000. The Court held that since the preferred had to be sold at par, the common was issued for nothing; and since it was illegal to issue stock for no value, the corporation, and hence the receiver, was barred from recovering on the illegal transaction.

(2) *Estoppel*. When a corporation, acting through its directors, makes a bargain with a purchaser of stock, it is bound by the bargain and estopped from claiming that the bargain was unfair or invalid.⁸³

Examples:

(1) A corporation that issues stock as "fully paid and nonassessable," though the full value thereof has not been paid, is estopped from thereafter trying to hold the stockholder for the difference.⁸⁴

(2) Stock having a par value of \$100 was issued for \$25 a share. The corporation agreed with the stockholder that the amount of his investment was to be the limit of his liability. The corporation was adjudicated a bankrupt and the trustee in bankruptcy sued the stockholder for the difference between the par value of the stock and the amount actually paid by the stockholder. The Court, in dismissing the case, held that the trustee stood "in the shoes" of the corporation; and since the corporation was estopped by its bargain, so was the trustee.⁸⁵

(3) *Waiver*. As previously noted (sec. 837, subd. (a)), a corporation may refuse to record a stock transfer on its books unless the stock has been fully paid. Once the corporation records the transfer, however, it waives any claim against the transferor and accepts the new stockholder as a substitute debtor; that is, the transaction amounts to a *novation*⁸⁶ (sec. 212).

Example: Raymond, a stockholder, who was also a director, owed \$2000 to the corporation on his stock. Knowing that the corporation was in financial straits, he transferred his stock for \$3 to a waiter in a restaurant

⁸¹ *Butcher v. Federal Baseball Club of Baltimore*, 130 Md. 635, 101 A. 534; *Drees v. Minnesota Petroleum Co.*, 189 Minn. 608, 250 N.W. 563, 564; *Norfolk Motor Exchange v. Grubb*, 152 Va. 471, 147 S.E. 214.

⁸² 210 App. Div. 303, 206 N.Y. Supp. 95.

⁸³ *Stoecker v. Goodman*, 183 Ky. 330, 290 S.W. 374.

⁸⁴ *Thompson v. Knight*, 74 App. Div. 316.

⁸⁵ *Southworth v. Morgan*, 205 N.Y. 293.

⁸⁶ *Schmitt v. Kulamer*, 267 Pa. 1, 110 A. 169.

and caused the transfer to be registered on the corporate books. The corporation subsequently sued Raymond. The Court held that the corporation, having registered the transfer of Raymond's stock on its books, had waived its remedies against Raymond.⁸⁷

Liability for unlawful dividends. A stockholder is generally liable to the corporation for illegal dividends received by him. "Generally, dividends paid by a corporation out of capital may be followed into the hands of stockholders to the extent necessary to pay the debts of the corporation, and the liability of directors in such a case does not exonerate the stockholders from liability."⁸⁸ (For an example, see sec. 1672.) If a corporation fails to enforce restitution, a stockholder or judgment creditor may do so.⁸⁹

866. Liability of stockholders to judgment creditors of the corporation. The statute gives judgment creditors of a corporation a right of action against stockholders who for one reason or another are obligated to the corporation. Such obligations to the corporation represent corporate assets in the form of *choses in action* (sec. 1054); and to the extent that a corporation has assets, judgment creditors are entitled to be satisfied.

There are various types of stockholders' obligations to which a judgment creditor of the corporation may thus resort:

(a) *Unpaid stock subscriptions.* These include not only ordinary unpaid balances on a stock subscription, but also cases where a corporation issues original stock for less than its full value. Although, as noted in sec. 865, the corporation may be barred from bringing suit for such deficiency, a judgment creditor is not.

Examples:

(1) Hurd subscribes for 50 shares of stock of the Basswood Furniture Co. but fails to pay any part of his subscription. Later, the corporation becomes insolvent. The creditors in such case may compel Hurd to make good his subscription.

(2) See sec. 1651.

(b) *Watered stock.* Where stock is watered (sec. 787), the stockholder receiving such stock for less than its true value may be compelled to make good the deficiency to judgment creditors.

(c) *Unlawful dividends.* As noted in sec. 865, judgment creditors of the corporation may compel stockholders to make restitution to the corporation for unlawful dividends received by them, so that the proceeds of such restitution will be available for the discharge of such judgments.

(d) *Double liability.* Prior to the establishment of the Federal Deposit Insurance Corporation, stockholders were individually responsible for the obligations of a national bank to an extent equal to the par value of the

⁸⁷ *Rochester and Kettle Falls Land Co. v. Raymond*, 158 N.Y. 576.

⁸⁸ 18 *Corpus Juris Secundum* 1323.

⁸⁹ *Gager v. Paul*, 111 Wis. 638.

amount of stock that they held. This meant that a stockholder in a national bank might not only lose the amount of his investment but also be personally liable for an additional amount equivalent to the par value of stock held by him in the bank. This was known as a stockholder's "double liability." Stockholders of many state banks were subject to a similar liability. The elimination of double liability on the part of stockholders of national banks was coincident with the establishment of the Federal Deposit Insurance Corporation. State practice governing banks and trust companies has followed the lead of Congress in eliminating liability on the part of bank stockholders. Statutory and constitutional amendments have been adopted in more than half of the states repealing double liability. States that still retain full double liability include Arizona, Illinois, Indiana, Minnesota, Oregon, Utah, Washington and West Virginia. States retaining a limited double liability include Arkansas, California, Colorado, Kansas, Maine, Mississippi, Montana, New Hampshire, Oklahoma, Pennsylvania, South Dakota, Vermont, Wisconsin and Wyoming.

867. Liability to wage earners. In many states, stockholders of a corporation are personally liable for unpaid wages. In New York, for example, a wage earner may within thirty days after terminating his employment notify any stockholder in writing that he intends to hold him personally liable for his unpaid wages if he cannot collect them from the corporation. If the wage earner then procures a judgment against the corporation for unpaid wages and is unable to collect it, he may hold the stockholder personally for the amount of the judgment.

868. Liability where foreign corporation fails to register. A state may compel all foreign corporations doing business therein to file certificates authorizing them to conduct such business, and upon their failure to do so, may impose various penalties, including personal liability of stockholders for corporate debts. (See secs. 875-876.)

J. Corporate Rights, Powers and Liabilities

869. The corporation as a person. Generally speaking, corporations are endowed by law with the same rights, powers and responsibilities as natural persons. They may buy, own, hold and sell property. They may make contracts. They are liable for their debts, torts and agreements. They may sue and be sued. In short, as pointed out in sec. 725, a corporation is treated in law as a person in its own right, separate and distinct from the human beings behind it.

However, where the corporate device is used to perpetrate a

fraud, the corporate fiction may be disregarded. Moreover, by their very nature, corporations differ from individuals in certain basic respects, namely, as to existence, citizenship, scope of power and amenability to punishment.

870. Disregarding the corporate fiction: fraudulent devices. Where persons utilize the corporate entity for the achievement of illegal or fraudulent ends, the courts will penetrate the corporate fiction and deal directly with the realities. Thus, persons will not be permitted to evade existing debts and obligations by resorting to the corporate form of doing business.

Examples:

(1) Smith discovered that his government land grants were void. Anticipating a suit to annul the grants on the ground of fraud, Smith formed a corporation and deeded the lands to it, but suppressed the transfer by failing to record his deed to the corporation. The government, assuming that Smith was still the owner, sued Smith, who contrived to drag the law suit out for more than six years, by which time the statute of limitations would normally outlaw such government suits against the true owner. Smith then disclosed that he was no longer the true owner. Upon discovery of the facts, the United States Supreme Court refused to allow Smith's trick to succeed. The corporation, being wholly owned by Smith, was charged with knowledge of the facts and was required to give up the lands.⁹⁰

(2) A group of men sold out a fish business and, in so doing, agreed not to engage in the fish business in the same locality. Immediately thereafter, they organized a corporation to carry on the fish business in competition with the old concern. Ignoring the corporate entity, and granting an injunction against this violation of an agreement not to compete, the Court pointed out that "a court of equity looks at the substance, and not merely at the form."⁹¹

However, where the corporation is not chargeable with guilty knowledge of the wrong, the Court will not disturb the corporate fiction.

Example: Where the owner of a business sells its assets to a corporation but says nothing about its liabilities, and the corporation has no knowledge of such liabilities, the creditors of the old business have no redress against the corporation. But where the corporation was formed or is largely owned by the seller, its separate existence will be disregarded and it will be deemed merely an *alter ego* of the seller.

871. Corporate existence. The life of a corporation is prescribed in its certificate of incorporation. It is now customary

⁹⁰ *Linn & Lane Timber Co. v. United States*, 236 U.S. 574.

⁹¹ *Booth v. Siebold, et al.*, 37 Misc. 101, 74 N.Y. Supp. 776.

for incorporators to provide for perpetual existence. Failure to do this frequently results in the inconvenience and expense of filing a new certificate for the purpose of extending corporate existence.⁹²

872. Citizenship: when corporation deemed citizen, when not. A corporation is a citizen for some purposes but not for others. For jurisdictional purposes (taxation, for example), a corporation is a citizen of the state where it is incorporated. From the standpoint of Article IV of the United States Constitution ("Citizens of each State shall be entitled to all the Privileges and Immunities of Citizens in the several States") a corporation is not a citizen because, to do business as a foreign corporation in another state and to have the right to sue on such business in such state, it must first procure a certificate from the Secretary of State and pay a fee to that state for the privilege of doing business there.

873. Foreign corporations: license requirements. The license requirements for the purpose of authorizing foreign corporations to do business in a given state depend upon the laws of that particular state. The usual procedure is to file an application certifying the corporation's name, date and state of incorporation, the nature of its business, the location of its principal office, the proposed registered office, the names and addresses of officers and directors, the name of the proposed resident agent on whom process may be served, facts in reference to capitalization, value and similar information, together with a certified copy of the certificate of incorporation. This information must be accompanied by a registration fee.

874. Foreign corporations: what constitutes doing business. It is not easy to define what constitutes "doing business" in a given state. Isolated deals, mail-order transactions and transactions that are purely interstate in character have been held clearly not to constitute "doing business." The law generally contemplates a more or less permanent and continuous business establishment, evidenced by the appointment of some local business agent, or by a branch store, or by a listing in a telephone directory, or similar indications that the business that is being done is not merely temporary or isolated. Acts

⁹² The head of a well known accounting firm writes to the author: "Probably it will not be a surprise to you that I have found more than one bond issue the maturity of which was subsequent to the expiration of the charter."

relating to internal management, such as issuing stock certificates, depositing money, conducting research, training employees or holding meetings, do not constitute "doing business" in the sense requiring a foreign corporation to obtain a license in the state. Making contracts that are *subject to approval outside the state* is not construed as "doing business" in the state.

Examples:

(1) Merely holding property in a given state would not constitute doing business there.

(2) A Philadelphia corporation, one of whose vice presidents has an office in Trenton, New Jersey, where he devotes his time to research, editing printed literature and training employees for the corporation, would not be regarded as "doing business" in the State of New Jersey; and a New Jersey summons served upon such vice president would be set aside for want of jurisdiction.

(3) If the X Company of Pennsylvania manufactures articles and merchandises them through the A Company in Massachusetts, the X Company is doing business in Massachusetts through the A Company as its agent. If, however, the X Company, by mail or otherwise, accepts orders from other states and ships direct from Pennsylvania to such states, it will be regarded as doing an *interstate* business and will not be subject to state taxation of such business nor to the penalties imposed for doing business in a state without a license.

(4) If a Missouri corporation makes contracts in New York, which, however, *are not complete until accepted in Missouri*, such contracts are regarded as Missouri contracts and not as New York contracts, and the Missouri corporation will not be regarded as doing business in New York. (See sec. 1683.)

875. Doing business without license: corporate penalties. In addition to personal penalties (sec. 876), states may impose fines upon a foreign corporation doing business in a given state without a license. However, the most common penalty for such infraction is to deprive the offending corporation of the right to sue in such state for moneys due or for any other cause.

Example: In *The Truly Warner Company, Inc. v. Kaufman Hats, Inc.*,⁹³ plaintiff sued defendant for damages sustained by having been kept wrongfully out of a store it had leased on a valuable Chicago corner. The lower court gave plaintiff judgment for \$44,921. On appeal the decision was reversed on the ground that plaintiff was a New York corporation, that it had not been qualified as a foreign corporation in Illinois, and that it was doing business in the state and therefore had no right to maintain an action in the Illinois courts.

⁹³ 352 Ill. 541, 186 N.E. 167.

876. Doing business without license: personal penalties. As noted in sec. 826, personal liabilities and penalties are imposed by some states upon stockholders, directors and officers of a foreign corporation doing business in the state without a license. These may include personal liability for corporate debts, fines, and, in some cases, imprisonment.

Examples:

(1) In *Equitable Trust Co. v. Central Trust Co., et al.*,⁹⁴ a Scottish bank had more or less involuntarily become a stockholder of a corporation by having been forced to take the stock in settlement of a debt. The corporation had done business in Tennessee without having qualified as a foreign corporation. The bank in question, as stockholder, was held liable for the company's debts in the state, and judgment was awarded for the sum of \$146,637.39.

(2) In *Critchfield and Co. v. A. Watson Armour, et al.*,⁹⁵ a corporation known as the Tireoid Company kept an office in Chicago and employed the services of a Chicago advertising agency. In the course of time the corporation became insolvent. It owed the advertising agency a debt of \$15,710.50. The agency discovered that the company was a foreign corporation not qualified to do business in Illinois, and that some of its directors were wealthy Chicago citizens. Suit was brought against these directors personally, and judgment was obtained against them for the full amount of the debt.

877. Scope of corporate power. A corporation has only such power as is (1) expressly conferred by charter or (2) reasonably implied therefrom. Acts of a corporation within its express or implied powers are *intra vires*; outside of its express or implied powers, *ultra vires*.

Certain powers, though not expressed in the charter, are implicit in the nature of corporate activity, such as perpetual succession; the power to sue and be sued in the corporate name; the power to take, hold, sell and convey real and personal property for corporate purposes; the power to have a corporate seal; the power to make by-laws; and the power to do all acts reasonably necessary to carry out the corporate objects and purposes. Beyond these, the question as to what constitutes an implied power is one on which the courts are at variance.

Examples:

(1) May a corporation engage in selling *electrical supplies* made by other

⁹⁴ 145 Tenn. 148.

⁹⁵ 228 Ill. App. 28.

concerns if its sole object is to *manufacture electrical appliances*? The court has answered this question in the negative.⁹⁶

(2) Does a railroad corporation have implied power to guarantee expenses of a "World's Peace Jubilee and International Music Festival" on the ground that the latter would stimulate railroad traffic? The court said no.⁹⁷

(3) If the Ford Motor Company was formed for the sole purpose of making automobiles, as expressly provided in its certificate of incorporation, could a power be reasonably implied to operate a smelter to make castings from iron ore to be used in its cars? The court held that the company had such an implied power.⁹⁸

(4) Has a corporation with the express power to operate an office building the implied power to operate, in conjunction therewith, a laundry to furnish towels to its tenants, such business being incidental to the efficient operation and management of the building? The court said it has.⁹⁹

(5) Has a laundry corporation, expressly authorized to lease and otherwise deal in real estate and personal property and to do anything to enhance the value of its property and rights, the power to operate a lumber business? The court said it has.¹⁰⁰

(6) May a lumber manufacturing corporation publish a newspaper? The court held that it could, because such a newspaper may be considered primarily as an advertising medium, useful in promoting sales.¹⁰¹

Regardless of the scope of implied corporate powers, the law, on grounds of public policy, limits a corporation in respect to the following rights, powers and functions: (1) The right to become a partner; (2) the right to buy its own stock; (3) the right to buy stock in other corporations; (4) the power to lend money; (5) the power to guarantee obligations; (6) the power to indorse for accommodation; and (7) the right to practice a profession.

878. Right of corporation to become partner. We have already noted (sec. 619) that a corporation, from its very nature, does not have the power to become a partner, though it may be estopped to deny liability as such. As pointed out in the chapter on "Partnership," each partner may bind his copartners by acts within the scope of the partnership. If corporations could become partners, corporate affairs could be con-

⁹⁶ *Powell v. Murray*, 157 N.Y. 717.

⁹⁷ *Davis v. Old Colony R. R. Co.*, 131 Mass. 258.

⁹⁸ *Dodge v. Ford Motor Co.*, 204 Mich. 459.

⁹⁹ *American Coat, Apron and Towel Supply Co. v. Grant Building*, 102 Pa. Super. 373, 157 A. 52. See sec. 2037.

¹⁰⁰ *People's Wet Wash Laundry Co. v. Debeau*, 80 N.H. 544, 119 A. 706.

¹⁰¹ *State ex inf. Gentry v. Long-Bell Lumber Co.*, 321 Mo. 461, 12 S.W. 2d 64.

trolled by persons who are neither stockholders, directors nor officers, and this would violate the basic principle of corporate management.

879. Right of corporation to buy its own stock. Some states (Washington, Missouri and California, for example) have held that a corporation cannot purchase its own shares of stock either to retire or to reissue them. The better rule, however, is that a corporation may acquire and hold its own stock, provided:

- (a) The transaction is fair and made in good faith.
- (b) The transaction is free from fraud.
- (c) The rights of creditors and other stockholders will not be prejudiced by the purchase.
- (d) The purchase is made out of an existing surplus.
- (e) The purchase will not cause the corporation to lose its surplus nor to become insolvent.
- (f) The corporation is not in the process of dissolution.

Corporate commitment v. corporate option to buy stock. An agreement by a corporation that *obligates* it to purchase its own stock in the future, either at a definite time or upon a contingent event, is unenforceable because at such future time the corporation may not have a surplus, in which event it could not be compelled to buy the stock. Since such an agreement would lack mutuality (sec. 147), it would be void from the start.¹⁰²

880. Right of corporation to buy stock in other corporations. On general principles, a corporation cannot buy stock in another corporation unless such power has been expressly granted to it in its charter or is necessarily implied from its express powers. Many states have statutes that expressly authorize a corporation under certain conditions to purchase and hold stock of other corporations. These statutes, for the most part, provide that any stock corporation (other than a moneyed corporation) may buy stocks or bonds of another corporation provided: (1) The power is expressly conferred by charter; or (2) the corporation whose stock is acquired is engaged in a business similar to that of the acquiring corporation so that the acquisition is reasonably incidental and necessary to the express objects and purposes of the latter; or (3) the corporation whose stock is acquired is one with which the acquiring corporation is authorized to consolidate. In no

¹⁰² *Topken, Loring & Schwartz, Inc. v. Schwartz*, 249 N.Y. 206.

event may one corporation purchase the stock of another except out of surplus.

881. Power to lend money. Ordinarily, a corporation has no power to lend money unless it is authorized to do so by charter pursuant to statute. A corporation that lends money as a business is a moneyed corporation, and moneyed corporations are incorporated under special banking statutes. There are situations, however, in which a corporation may find it necessary to lend money as an incidental part of its normal functions and powers.

Example: A Kentucky court has held that a corporation authorized to operate a public warehouse for receiving and storing tobacco and to buy, sell and resell the tobacco on commission, has authority to lend money to a customer on his growing crop.¹⁰³

The law makes a distinction between the *practice* of lending money and the granting of a temporary loan as an incidental and necessary part of the corporation's business.

Corporate loans to directors, officers and stockholders are generally prohibited, with penalties for violations. (See sec. 822.)

882. Power to guarantee obligations. Ordinarily, a corporation has no power to become a guarantor or surety or to lend its credit to another person or corporation. There are, however, two exceptions to this rule: (1) Guaranty and surety bonds issued by a company engaged in such business, and (2) guaranties made in furtherance of corporate business.

Example: A parent corporation owns all the capital stock of a building company that is required to procure a completion bond on a building contract. The surety company refuses to issue a completion bond unless the parent corporation guarantees the subsidiary corporation's indemnity to the surety company required in connection with such bond. Such guaranty by the parent corporation would be valid.

883. Power to indorse for accommodation. A corporation cannot indorse negotiable paper for another's accommodation. Any person who accepts a negotiable instrument in reliance upon such indorsement is presumed to do so with knowledge of its invalidity and cannot hold the corporation on such an instrument. However, where a bona fide holder for value takes negotiable paper bearing a corporate indorsement, without

¹⁰³ *Holt v. Farmers Loose Leaf Tobacco Warehouse Co.*, 201 Ky. 184.

notice that such indorsement was made without consideration and was purely for accommodation, he may enforce collection on the instrument.

884. Right to practice profession. We have already pointed out that the law generally prohibits corporations from practicing the learned professions (secs. 634 and 729, subd. (6)). Statutes generally prohibit corporations from practicing law, medicine, dentistry, architecture and even optometry. A corporation that renders such professional services may recover nothing for them, and if they were tied into an otherwise valid contract, the entire contract fails, though the services were only a small part of the contract. See, in this connection, sec. 160, Example 2.

885. Corporate liabilities: contracts. A corporation, as previously noted (secs. 743-745) is not liable on contracts made in its behalf prior to its incorporation except where such contracts are expressly or impliedly adopted. Neither is a corporation liable on illegal contracts, though in some cases it may be liable for *ultra vires* acts.

Illegal v. unauthorized acts. A distinction must be noted between corporate acts that are invalid because they are prohibited by law, such as crimes and statutory violations generally, and corporate acts that are not invalid in themselves but which are invalid as to the corporation because they are *ultra vires*—beyond the express or implied powers of the corporation.

886. Ultra vires acts: when enforceable and when not. Not all *ultra vires* acts are unenforceable. A corporation may, in certain cases, be estopped to deny liability on its *ultra vires* acts. Likewise, estoppel may prevent a third party from taking advantage of the *ultra vires* plea. *Ultra vires* contracts may involve the following situations:

(1) *Where neither the corporation nor the third party has performed.* In such situations, neither party can enforce the contract against the other.

Example: By agreement with Nassau Bank, Jones subscribed for \$90,000 worth of railroad securities, including stock, in which the bank was to have a one-half interest and for which it was to pay one-half the purchase price. Jones bought the stock, made a large profit. The bank claimed one-half the profits. It had not yet contributed its half of the price, nor had Jones paid over any of the profits. Held: The contract being executory on both sides and the agreement with Jones being *ultra vires* (the bank had no right to invest in railroad stock), such agreement was unenforceable.¹⁰⁴

¹⁰⁴ *Nassau Bank v. Jones*, 95 N.Y. 115

(2) *Where both parties have performed.* In such situations, the contract being executed on both sides, neither party may sue to rescind it.

Examples:

(1) A fire insurance company issued a policy insuring against loss of crops by hail, and received the premium. The company later sought to escape liability for loss on the ground that it had no power to insure against loss by hail. Held: that, though the contract was *ultra vires*, the transaction would stand, since it had been executed on both sides.¹⁰⁵

(2) See sec. 1685.

(3) *Where the contract has been executed on one side but not on the other.* Here, the authorities differ. The Federal and some state courts declare such contracts void, but hold that the party receiving the benefit of the contract must pay the fair and reasonable value of such benefit, regardless of the agreed value under the contract. The majority of states hold that the party receiving full performance is estopped to raise the defense of *ultra vires*.

Example: A corporation borrows money for use in an *ultra vires* business, to the knowledge of the lender. It gives its note for the loan, but thereafter seeks to avoid liability on it because of the *ultra vires* character of the transaction. Held: that the corporation is estopped from setting up such defense.¹⁰⁶

(4) *Where there has been part performance on both sides.* Here the law generally enforces the contract to the extent that it has been performed but refuses to enforce the unexecuted part.

Example: Plaintiff contracted to sell excelsior to defendant corporation for *ultra vires* speculative purposes. After delivering a considerable quantity, plaintiff refused to deliver more. Defendant corporation refused to pay for what had been delivered unless the whole amount was delivered as agreed. Held: that plaintiff was entitled to recover for the excelsior actually delivered, though the contract was *ultra vires*, but that defendant could not recoup damages for failure to complete performance by delivering the balance.¹⁰⁷

887. Corporate liability for unauthorized acts of officers. Just as a principal is liable to third parties for acts of a general agent within the *apparent scope* of the latter's duties (sec. 567), so a corporation is liable to third parties for the acts of its officers—even when such acts are outside the scope of their actual duties as prescribed in the by-laws—provided such acts are customarily delegated to such officers. If such authority is not customarily delegated, third parties have no right to rely on it, as, for example, where the president of a corpora-

¹⁰⁵ *Denver Fire Ins. Co. v. McClelland*, 9 Colo. 11.

¹⁰⁶ *Bradley v. Ballard*, 55 Ill. 413.

¹⁰⁷ *Day v. Spiral Springs Buggy Co.*, 57 Mich. 146.

tion, without specific authority, undertakes to hire an employee for life.

Example: The president of X Corporation had power under the by-laws to appoint, remove and fix the compensation of employees. Without express authorization from or ratification by the board of directors, he made a contract on behalf of the corporation to employ Jones for life. Said the Court: "The president or other executive officer of a corporation has no authority as such to make a contract with one who remained in the corporate employ for life even under a general power 'to appoint, remove and fix the compensation of employees.' That any Board of Directors or other persons responsible for the management of a corporation should give such unusual power to an executive officer cannot be implied. Plain language of the managing board, clearly showing that such was the intention of the corporation, coupled with power actually or impliedly vested in the corporation itself, must be found to justify such a hire."¹⁰⁸

Restrictions on authority: when third parties bound by. Third parties are not bound by restrictions contained in by-laws, unless they have actual knowledge of them. They are, however, chargeable with knowledge of *legal restrictions* and of those set forth in the certificate of incorporation. The reason for this is that everyone is supposed to know the law and everyone is supposed to have constructive notice of filed documents. A charter must be publicly filed; by-laws need not be.¹⁰⁹

Liability for notes and checks improperly signed. Even though the by-laws of a corporation provide that some specific officer or officers must sign all checks, notes, and so on, the corporation is liable on instruments signed by an officer without such authority where the corporation, with full knowledge, has received the benefit of the transaction.

Example: The by-laws of a corporation provide that the treasurer or, in his absence, the president or vice president shall sign checks, notes, and so on for the company. A note for \$10,000 is made out by the company to itself and indorsed in blank. Albert Smith, who is both secretary and treasurer, signs the note as follows: "The X Company, by Albert Smith, Secretary." The note is negotiated at the bank, but on maturity the corporation refuses to pay on the ground that the note is not signed properly. The corporation, having received the benefit of the transaction, is obligated on the instrument regardless of irregularity in signature.

However, where an officer indorses checks payable to the corporation and deposits them in his personal account and the bank collects the proceeds and pays them out on the officer's personal checks, the bank and not the corporation must stand the loss, since the bank in such case is charge-

¹⁰⁸ *Heaman v. E. N. Rowell Co., Inc.*, 261 N.Y. 229.

¹⁰⁹ This rule, however, is not uniform. There are states that refuse to recognize the mere filing of a certificate of incorporation as constructive public notice of its contents. Indeed, the Uniform Business Corporation Act specifically provides that "No person dealing with the corporation shall be charged with constructive notice of the contents" of such certificate or amendments thereto.

able with knowledge that the funds were diverted from corporate purposes. (See sec. 1627.)

888. Corporate torts. A corporation, like a natural person, is liable for all torts committed by its officers, agents or employees during the course and scope of their corporate duties. It is no defense that the acts or transactions, in connection with which such torts occurred, were *ultra vires*. "It is to be kept in mind that all torts are necessarily *ultra vires*, since if an act is authorized by a valid statute it is for that reason lawful and not a tort." ¹¹⁰

889. Corporate crimes. Corporations, like individuals, are capable of committing crimes. These may include statutory offenses, such as making a political campaign contribution, rebating, or violating a labor or an antitrust statute. Corporate crimes may also be of the so-called "common law" variety (sec. 34), although it has been held that unless the statute so provides, a corporation cannot commit homicide, particularly where the statute defines homicide "as the killing of one human being by *another*." ¹¹¹ At any rate, since a corporation is a fictitious being, it cannot be imprisoned. Punishment must necessarily take the form of fines, or forfeiture of charter, which is equivalent to corporate death.

K. Insolvency and Receivership

890. Insolvency defined. Insolvency has various meanings. Under the National Bankruptcy Act, a person is insolvent if the aggregate value of his assets, at a fair valuation, is insufficient to pay his debts (sec. 1281). As defined by courts of equity, however, insolvency means inability to meet one's debts as they mature. If a corporation is unable to meet its debts as they mature, creditors may seek equitable remedies not otherwise available.

891. Position of creditors when corporation becomes insolvent. Ordinarily, a creditor of a corporation has no right to interfere with its affairs. If creditors are not paid, they may sue the corporation, just as they may sue anyone else. However, when a corporation becomes insolvent or when its insolvency is threatened or imminent, creditors are concerned to the extent that the corporate assets are jeopardized. In such

¹¹⁰ *Ziegler v. Denver Hog Serum Co.*, 204 Minn. 156, 283 N.W. 134, 137.

¹¹¹ *People v. Rochester Railway and Light Company*, 195 N.Y. 102.

cases, a court of equity may intervene to grant exceptional relief. Such relief may take the form of actions or proceedings on behalf of all creditors ("representative actions") for relief in respect to the following:

- (1) Fraudulent and preferential transfers.
- (2) Receivership in sequestration proceedings.
- (3) Receivership to reach equitable assets.
- (4) Receivership to preserve corporate assets.
- (5) Receivership to restrain unlawful transfers.

Creditors' bills. A *creditor's bill* is a *bill in equity*, meaning a "bill of complaint" or complaint brought in an equity court, seeking some form of equitable remedy available to creditors.

892. Fraudulent and preferential transfers. The rule governing fraudulent or preferential transfers by a corporation while insolvent or while in a condition which would result in insolvency by reason of the transfer, is the same as that governing any other fraudulent or preferential transfer.¹¹² (See sec. 430.) The law views with particular suspicion any corporate transfer to an officer, director or stockholder, or to any of their relatives, because such transfers frequently prejudice the rights of creditors.

Examples:

(1) A corporation, the insolvency of which was imminent, sold its bonds to the wife of one of its officers. The proceeds of these bonds were used to pay the corporation's debts to the officer. The Court held that this constituted an illegal preference; that the wife was not an innocent purchaser for value and that the obvious intent was to prefer her husband.¹¹³

(2) A corporation was organized to build and rent apartments. It leased an apartment to the wife of its president at a rental of One Dollar per month. The wife thereupon sublet the premises for a substantial rent. The Court held that this constituted an illegal transfer of corporate property to an officer and that on the insolvency of the corporation, a judgment creditor might compel the wife to account for the rents received.¹¹⁴

893. Receivership: nature and classification of. Receivership denotes two things: (1) A remedy in equity and (2) a status or condition involving the appointment of a person by a court to take into his custody, control and management the property or funds of another person, or of a business, pending some final action by the court.

¹¹² *La Crosse Mfg. Co. v. Springer*, 323 Ill. App. 525, 56 N.E. 2d 146.

¹¹³ *Davis v. Seneca Falls Mfg. Co. Inc.*, 8 Fed. 2d 546, aff'd 17 Fed. 2d 546.

¹¹⁴ *Larsen v. Newmark*, 182 App. Div. 724, 117 N.Y. Supp. 268.

Equity receiverships are those wherein a receiver is appointed by a court of equity, by virtue of its inherent power to preserve the subject matter of a litigation pending its outcome ("pendente lite").

Statutory receiverships are those wherein a receiver is appointed pursuant to a particular statute.

Temporary receivers are appointed by the court as custodians to prevent waste of assets until a hearing can be held on the dispute affecting such assets.

Permanent receivers are appointed pursuant to a final judgment or order. Their tenure is more permanent and their authority and discretion are wider than in the case of temporary receiverships.

Among the major purposes of a receivership are the following: (a) to sequester assets; (b) to reach equitable assets; (c) to preserve corporate assets; and (d) to restrain unlawful transfers.

(a) *To sequester assets.* To "sequester" assets is to place them in the custody of the court or of a representative of the court, such as a receiver, so as to provide a fund out of which debts may be discharged. A sequestration proceeding may be brought upon application of a judgment creditor who has had an execution returned unsatisfied (sec. 73). The Court takes possession of the assets for the purpose of applying them ratably in payment of debts.

(b) *To reach equitable assets.* Where a corporation has no tangible assets, but has claims against others that may be realized by instituting suit, a court, upon application of a judgment creditor, may appoint a receiver for the purpose of reaching such equitable assets so that they may be applied to the satisfaction of creditors' claims.

(c) *To preserve corporate assets: equity receivership.* Where impending lawsuits threaten to deluge a corporation with judgments so as to paralyze its continued existence or the conduct of its business, a corporation may, under exceptional circumstances and upon proof that it will serve the best interests of all creditors to do so, appoint a receiver in equity to take charge of corporate affairs until they can be straightened out; and in the meantime, the threatened lawsuits will be restrained so as to permit the receiver to continue to operate the business unmolested by creditors' suits.

(d) *To restrain unlawful transfers.* Under exceptional circumstances, a court may appoint a receiver to prevent a corporation from carrying out a threatened transfer of corporate property that would leave the corporation unable to pay its debts, or, if such transfer has been effected, to cause the transaction to be set aside as a fraudulent transfer.

L. Succession: Purchase, Merger, Consolidation and Reorganization

894. Succession defined. "Succession," literally, is the transmission of the rights and obligations of a deceased person to

his heirs. A corporation, being an artificial person, cannot have heirs, but it may have successors. One corporation may succeed to the rights of another (1) by purchase, (2) by merger, (3) by consolidation and (4) by reorganization.

895. Succession by purchase of assets. The power of a corporation to buy or sell assets in the normal conduct of its affairs depends, as previously noted, upon its express or implied powers. However, in the purchase or sale of the entire assets of a corporation, there are certain fundamental rules that must be observed:

(1) *The transaction must not be contrary to charter or statute.* The purchase or sale of the entire assets of a corporation must be expressly or impliedly permitted by charter. Moreover, the statute generally requires a minimum vote of stockholders, such as a two-thirds vote (sec. 841), to validate a sale of entire assets.

(2) *The transaction must not violate public policy: antitrust laws.* Where the purchase and sale of assets will have the necessary effect of creating a monopoly or of restraining trade, the transaction is held contrary to public policy and is generally prohibited by statute. Most states have antitrust statutes reflecting the general policy of the Federal Government in respect to combinations in restraint of trade.

(3) *The transaction must not be in fraud of creditors.* See secs. 430 and 431.

896. Merger and consolidation. Succession by merger and consolidation involves no direct transfer of corporate property but rather of corporate rights as a whole. Consolidations and mergers, though frequently confused, are not the same. Upon a consolidation, a new corporation comes into existence and the prior corporations cease to exist. Upon a merger, the existence of one of the corporations is continued without the formation of a new corporation and the others are absorbed by the surviving corporation, so that the continuing corporation becomes a successor of the merged corporations, subject to the rights and obligations imposed by statute. Neither merger nor consolidation can wipe out the rights of creditors without their consent, and the continuing corporation in the case of a merger, or the new corporation in the case of a consolidation, becomes liable for the debts of the merged or consolidated corporations. (See sec. 1636.)

Unauthorized mergers: rights of dissenting stockholders. The right of corporations to merge or consolidate is not absolute but may be limited by statute. For example, in New York one corporation cannot merge others

with it unless the business of the merged corporations is similar to that which the merging corporation is expressly or impliedly authorized to transact. Consolidations, as previously noted (sec. 841), require a two-thirds vote of stockholders. In both mergers and consolidations, dissenting stockholders may require an appraisal of their stock and its purchase by the corporation upon the basis of such appraisal. Antitrust laws further limit the unlawful combination of corporations in restraint of trade, whether by merger, consolidation or otherwise.

897. Reorganization. Reorganization, as applied to a corporation, means a re-arrangement of the interests of creditors and security holders, usually through the formation of a new corporation organized to take over the business of the old. The most common purpose of a corporate reorganization is to scale down capital obligations at a minimum sacrifice to stockholders, bondholders and unsecured creditors, so as to permit the corporation to continue in business instead of "folding up" with the usual losses entailed by a forced liquidation. Corporate reorganizations may be brought about in the following ways:

- (1) Voluntarily, by agreement of all parties.
- (2) By forced or judicial sale upon foreclosure.
- (3) By decree without sale.
- (4) By proceedings under the National Bankruptcy Act.

(1) *Voluntary reorganization.* Where all parties (including creditors) agree, a corporation may reorganize by transferring all its property to a new corporation. The new corporation may issue shares, bonds, debentures or other forms of security to the stockholders, bondholders and other creditors of the old corporation, pursuant to the agreed plan of reorganization. Such transfer cannot deprive nonassenting bondholders, or others having a lien on the property of the old corporation. Neither can it deprive creditors generally of the right to proceed against the new corporation, if the effect of the transfer is to defraud the creditors of the old. One cannot without his consent be compelled to accept a new creditor.

(2) *Reorganization by forced or judicial sale upon foreclosure.* Frequently, the property of a corporation is subject to a mortgage or deed of trust given to secure bonds issued to widely scattered holders. If the corporation defaults in principal or interest on such mortgage or deed of trust, the bondholders have a right, through the mortgagee or trustee, to bring foreclosure proceedings. Often in such proceedings, groups of bondholders form a plan to purchase the property of the corporation at the foreclosure sale and to transfer such property to a new corporation. Agreements are formulated in connection with such plan by which bondholders consent in advance to an exchange of their claims for bonds or stock in the new corporation. The purpose of such reorganization plans is to prevent corporate property from selling at distress prices. Bondholders' committees, in bidding at such sales, have the advantage of being able to apply, on account

of the purchase price, the claims due bondholders whom they represent and on whose behalf the foreclosure was instituted. Reorganization procedure upon forced or judicial sale is frequently governed by statute.

(3) *Reorganization by decree without sale.* Small groups of creditors frequently block voluntary reorganizations by refusing to accept, in satisfaction of their claims, stock and securities instead of cash. Ordinarily such groups will succeed in sustaining their legal position. However, in a leading case¹¹⁵ the Court, through its power of taking over corporate property by means of an equity receivership, compelled unsecured creditors to submit to a plan of reorganization by which they were to receive a fair share of property or stock in payment of their claims.

(4) *Reorganization in bankruptcy proceedings.* See secs. 1350-1351.

M. Dissolution

898. Dissolution defined. The dissolution of a corporation means the termination of its existence by surrender, cancellation or other extinguishment of its charter so that not only are the corporation's affairs wound up and its assets distributed among creditors and stockholders, but the corporation also ceases to exist as a corporation. A mere sale of a corporation's entire assets, or the appointment of a receiver, or an assignment for the benefit of creditors does not accomplish corporate dissolution.

Dissolution may be *voluntary* or *involuntary*.

899. Voluntary dissolution. Dissolution is voluntary when brought about by the corporation itself. Such dissolution may arise in any one of the following ways:

(a) *Termination of charter.* The charter of a corporation may provide for a fixed period of corporate existence, upon termination of which the corporation is automatically dissolved.

(b) *Merger or consolidation.* See sec. 896.

(c) *Filing certificate without judicial proceedings.* Where the charter provides for perpetual existence, the stockholders may voluntarily bring about the surrender of the charter by filing a certificate for this purpose in accordance with the statute. This may be done (1) by incorporators prior to the commencement of business or the issuance of shares, (2) by the written consent of all outstanding stockholders, or (3) by resolution at a stockholders' meeting, upon a minimum required approval (such as a majority or a two-thirds vote of the holders of outstanding stock).

(d) *Judicial proceedings on petition.* Where the required vote of stockholders cannot be obtained and it can be shown to the Court that a dissolution is desirable in the interests of the corporation and its stockholders, judicial proceedings may be instituted by stockholders on petition for an

¹¹⁵ *Phipps v. Chicago R. I. & P. Ry. Co.*, 284 Fed. 945.

order permitting and directing dissolution. Such petitions are sometimes presented where the corporation is hopelessly deadlocked.

900. Involuntary dissolution. Involuntary dissolution may be brought about, either (a) at the instance of the state, acting through the attorney-general, or (b) at the instance of a judgment-creditor or stockholder, acting through the attorney-general or directly if the attorney-general refuses to act.

Quo warranto (literally, "by what right," or "by what warrant") is the old legal term applied to proceedings by which inquiries are made into the right of a corporation to exist and conduct business as such.

Dissolution by state. Dissolution may be brought about at the instance of a state upon any of the following grounds: (1) Non-user, as where a corporation fails to organize, commence business or undertake its duties within a given period; (2) fraud or fraudulent concealment in procuring a charter; (3) violations of a statute; (4) forfeiture, surrender or abuse of the corporate privilege or charter, or (5) a failure to exercise powers or to do or omit some act that amounts to a surrender of corporate rights, such as a continuous failure to pay taxes.

Dissolution at instance of creditor or stockholder. Dissolution may be brought about by the attorney-general at the instance of a creditor or stockholder where, for a given period, the corporation has (1) remained insolvent, or (2) neglected or refused to pay and discharge its notes or other evidences of debt, or (3) suspended its ordinary and lawful business.

901. Procedure on dissolution: distribution of assets. As previously noted, the assets of a dissolved corporation belong to the stockholders in the order of their priorities and preferences as fixed in the charter. However, creditors' claims must first be discharged before such assets can be distributed to stockholders. These claims include (1) tax claims, (2) secured claims, and (3) unsecured claims. After all debts are paid, the distribution to stockholders is in order.

Distribution of assets before paying debts. Where assets are distributed before all debts are paid, stockholders may be compelled to account for the assets to the extent necessary for payment of such debts. If they are no longer able so to account, directors become liable to the extent that the distribution deprived creditors of their ability to collect.

Example: A corporation in financial difficulties sold its assets and distributed the proceeds to the stockholders as a liquidation dividend. Upon an adjudication in bankruptcy, the trustee may compel the stockholders to make good to the creditors.

Effect of dissolution: survival of rights and liabilities. Upon dissolution, a corporation ceases to exist as such. It no longer has the customary rights or liabilities of a corporation. It can neither sue nor be sued, hold or convey property, make contracts, or exercise any of the corporate pow-

ers provided for by its charter—in short, the corporation, legally speaking, is dead.

However, statutes generally continue a corporation's existence after dissolution for such period and within such limits as may be necessary to complete liquidation and wind up its affairs. As an incident to such purpose, the corporation may prosecute and defend suits, recover contingent or unrealized assets, and dispose of contingent and unmatured liabilities, to the end that all debts may be paid and all net assets distributed among the stockholders. All other corporate transactions entered into after dissolution are void and unenforceable. (See sec. 1627.)

Questions and Problems for Review

1. (a) What is a corporation? (b) For what purposes may a corporation be formed? (c) Who may form a corporation? *NY May 1925 (4)*

2. What is the nature of corporate title? *NY June 1920 (1); NY Jan. 1917 (1)*

3. The X Corporation owns certain personal property of which B has wrongfully taken possession. A owns all of the stock of the X Corporation and brings in his own name an action to recover the property from B. Is A entitled to recover? *AI Nov. 1920 (8)*

4. Give four powers possessed by a corporation that are not possessed by a copartnership. *AI Nov. 1925 (II-4)*

5. Explain the principal advantages of doing business as a corporation rather than as a copartnership or as an individual. *AI May 1923 (10)*

6. (a) Describe some of the principal advantages obtainable through the incorporation of a business now owned by an individual.

(b) Are there any disadvantages to be considered? *AI May 1919 (9)*

7. What principles must be observed in an attempt to show that a municipal bond issue is valid? *NY Apr. 1934 (10)*

8. What is a quasi corporation? *NY June 1917 (15)*

9. Can a corporation be organized without capital stock? *AI Nov. 1925 (I-6)*

10. Distinguish between corporation de jure and corporation de facto. What three elements are necessary to make a defective legal corporation a de facto corporation? *NY June 1916 (3)*

11. In what position does a promoter stand to a corporation and what is his liability as such? *NY May 1925 (15)*

12. To what extent is a corporation bound by agreements made by its promoters prior to and connected with its incorporation? *AI May 1921 (11)*

13. The XYZ Corporation was organized with a capital stock issue of \$5,000,000, all of which was sold to stockholders. At the end of the third year, the books of the corporation showed a net profit of \$800,000. The board of directors met and decided they would not declare a dividend to the common stockholders but would instead use \$600,000 for "increase in plant and equipment." Smith and several of the other stockholders are incensed and declare that the directors are overstepping their legal rights. Smith claims that when he subscribed for his stock prior to the grant of the charter, the promoter K told him that he (Smith) would be earning 12% on his money by the end of the third year of the corporation's existence. Smith says this statement alone will be a legal basis for compelling the directors to declare a dividend out of the \$800,000 surplus.

(a) Is Smith's contention correct? Why?

(b) May Smith and the other dissatisfied stockholders compel a declaration of a dividend at the time indicated? Why?

(c) If they can, what allegations would have to be set up in their complaint? Explain. *NY Nov. 1930 (15)*

14. C. A. Nimocks was a promoter engaged in effecting the organization of the Times Printing Company. On September 12, 1928, on behalf of the proposed corporation, he made a contract with McArthur for his services as comptroller for the period of one year beginning October 1, 1928. The Times Printing Company was incorporated October 16, 1928, and at that date McArthur commenced his duties as comptroller. No formal action with reference to his employment was taken by the board of directors or by any officer, but all the stockholders, directors and officers knew of the contract made by Nimocks. On December 1, 1928, McArthur was discharged without cause. Has he cause of action against the Times Printing Company? *AI Nov. 1930 (11)*

15. What is the distinction between the capital and the capital stock of a corporation, and how is the value of the stock measured and determined? *AI May 1918 (12)*

16. What is meant by issuing of stock, and in return for what may stock lawfully be issued? *AI Nov. 1919 (8)*

17. When a portion of the capital stock of a corporation is held by the corporation and stands in the name of the treasurer as trustee, may this treasurer vote the stock at an annual election of directors, and, if so, must he vote it as instructed by the old board of directors? *NY Apr. 1934 (15)*

18. What are the characteristics of preferred stock, and what are the rights of the holders thereof as to dividends and guaranteed dividends and preference in distribution of capital on liquidation? *AI May 1918 (14)*

19. A corporation's certificate of incorporation or charter provided in article A that holders of preferred stock should be entitled

out of surplus or net profits to cumulative dividends at 7%. Article E stated that in any liquidation or dissolution the preferred stockholders "shall be entitled to be paid in full the par value thereof and all unpaid dividends accrued thereon before any amount shall be paid or any assets distributed to the holders of the common shares." Article F read: "The preferred stock shall be subject to redemption at \$110 per share plus all unpaid, accrued or accumulated dividends thereon." The corporation was dissolved, and, after the payment of all creditors, the funds available for distribution did not amount to the total par value of the outstanding preferred and common stock. At the time of dissolution, no declared dividends remained unpaid and the preferred stockholders had received annually the full amount of their 7% dividends. How should the available funds be distributed between preferred and common stockholders? *AI Nov. 1932 (11)*

20. The XY Corporation has outstanding \$250,000 in 6% non-cumulative preferred stock and 2,500 shares of no-par-value common stock. During each of the years 1926, 1927 and 1928, the corporation made net profits of \$25,000. No dividends were declared in 1926 or 1927, the directors allowing the profits to remain in surplus. Late in 1928, the directors declared a dividend of 6% on the noncumulative preferred stock and \$23 per share on the no-par-value common stock. The preferred stockholders objected to the dividend on the common stock, claiming that they were entitled to receive 18% of the then existing surplus before any of it could be available for common-stock dividends. Was the objection valid? *AI May 1929 (7)*

21. For the purpose of financing a proposed new corporation, what would be the advantage, from the viewpoint of the corporation, of issuing six per cent cumulative preferred stock (redeemable), instead of six per cent twenty-year gold bonds? *AI Nov. 1927 (9)*

22. (a) What is meant by "cumulative dividends"?

(b) What is meant by "cumulative voting rights"?

For what purpose are cumulative voting rights usually given? *AI May 1920 (9)*

23. Theodore Crawford, in November 1925, subscribed for 100 shares of the preferred stock of the M Corporation and paid \$2000 to the corporation on account. Crawford was induced to make and did make this subscription wholly because the corporation's treasurer had formally represented to him that the corporation had a surplus at July 1, 1925, and had legally paid a dividend in the month of July 1925. Crawford sued for the rescission of his contract and the recovery of the \$2000, and the following facts were proved:

On January 1, 1925, the corporation's books showed a deficit of \$11,484.29. In the following May, a journal entry was made debiting deferred engineering and development expense and crediting surplus with \$22,167.95 for "expenses charged off in 1924, deferred to future operations." This amount was 80% of the 1924 expenditures

for engineering. At the same time, the corporation paid \$10,000 for 400 shares of its own common stock, which it proceeded to carry at an asset value of \$10,000, although the book value immediately prior to this purchase was \$6.27. The corporation declared and paid a dividend of \$1,591.55 in July 1925.

(a) On the facts as stated, should Crawford succeed in his action?

(b) If the facts as stated should be amplified, indicate the lines along which further inquiry should be made. *AI Nov. 1932 (5)*

24. What is the rule with respect to partially paid subscriptions to capital stock on which default is made of an installment, payable according to the resolution of the directors, under which sale has been made? *NY Jan. 1925 (11)*

25. *M*, a subscriber to the stock of the *Z* Corporation, fails to pay as required by the terms of his subscription. Is *M* properly chargeable with interest from the time of the default and can the corporation refuse to issue the stock till the principal and interest are paid? *NY May 1925 (3); NY June 1921 (13)*

26. The Lakeville Corporation forfeits a subscriber's stock for a nonpayment of calls. Is the subscriber thereby relieved from: (a) Liability to creditors of the corporation; (b) Liability to the corporation for the unpaid installments due on his subscription? *NY June 1921 (11)*

27. Richard Roe subscribes for capital stock in a corporation but fails to meet the calls made for payment; consequently the corporation forfeits his stock, which was partly paid for. Is the subscriber thereby relieved from liability to the creditors of the corporation, which subsequently went into bankruptcy? Why? *NY June 1919 (14)*

28. *A* enters into a written subscription agreement with four other persons whereby they are to organize a corporation for a certain purpose and whereby each binds himself to take a specific number of shares of stock. After organization of the corporation, *A* refuses to pay the subscription and to take the stock on the ground that it is not binding because 10% deposit to bind the subscription was not given by him. Is he liable? Explain. *NY Jan. 1917 (9)*

29. You render services connected with the reorganization of a corporation. These services are fairly and reasonably worth \$5000, and you render a bill to the reorganized corporation for that amount. At the request of the directors, you accept, instead of cash, 100 shares of the stock of the corporation, the shares being of the par value of \$100 each. (a) Is the issuance of the stock by the corporation proper? (b) Do you incur any liability by your acceptance? *AI Nov. 1921 (10)*

30. For what consideration may the capital stock of a business corporation be issued? Would your answer be the same if the stock to be issued was that of a national bank? *NY May 1928 (3)*

31. Y subscribed for 200 shares 8% cumulative nonassessable preferred stock, \$100 par value, of S Hotel, Inc. The agreement provided that he was to receive a bonus at the rate of one share of common stock without par value with each two shares of preferred. Installment payments were provided for, and certificates for shares purchased were not to be delivered to him except in proportion to the payments specified. The agreement provided as follows: "Interest at the rate of 6% on preferred stock to accrue respectively from the date of each installment payment until the beginning of the first quarter after date of opening of hotel, after which date the dividend will be 8% on such preferred stock." Y paid \$13,000 on an agreed subscription of \$20,000, and X, Receiver of S Hotel, Inc., sues to recover balance of subscription with interest. S Hotel, Inc., at time of execution of stock subscription agreement, had not yet engaged in business and had no assets, property or income other than the cash received from the sale of stock. Will X succeed? Give reasons. *NY Nov. 1928 (14)*

32. You enter into an agreement with the Y Corporation to purchase 100 shares of its preferred stock at its par value of \$100. The Y Corporation agrees to issue to you, upon receiving payment, the 100 shares of preferred stock and 10 shares of its fully paid non-assessable common stock of the par value of \$10. Upon payment you receive the stock, the common stock having printed across its face the words "Fully paid and nonassessable." Subsequently, the Y Corporation becomes insolvent and its trustee in bankruptcy sues you to recover \$100, the par value of the common stock. Can he recover? *AI Nov. 1928 (12)*

33. What are the qualifications of directors of a New York State corporation? How is the authority of individual directors exercised? May their authority be delegated? What is the legal relationship of the board of directors to the corporation? *NY Nov. 1930 (6)*

34. State (a) by whom the directors of a business corporation are elected, (b) by whom the officers are elected, (c) which of the officers, if any, of a business corporation must be a director. *NY May 1927 (12)*

35. Describe briefly the more important powers and duties of the directors of a mercantile or manufacturing corporation, and state some acts (1) which would render the directors personally liable, (2) be *ultra vires* on the part of the corporation. Explain what *ultra vires* means. *AI Nov. 1917 (12)*

36. Have directors of a corporation the right to rescind, alter or amend by-laws adopted by stockholders? If so, state under what conditions. If not, why not? *AI June 1917 (13)*

37. Have directors the power to vote or pay increased salaries to officers for past services rendered in the usual and ordinary course of business? Give reasons for your answer. *AI June 1917 (15)*

38. To what extent may directors delegate their powers to an executive committee? Give reasons for your answer. *AI June 1917 (14)*

39. The *Z* Corporation had a board consisting of fifteen directors. It adopted a by-law authorizing the board to appoint a committee of five of its members with authority to act whenever the board was not in session or could not be convened. This committee authorized, at one of its meetings, the sale of a bond and mortgage held by the corporation. Subsequently, the assignment of the bond and mortgage, executed in accordance with the authorization, was attacked on the ground that it was not the act of the corporation as it had not been authorized by the whole board at a board meeting. Was the claim made correct? *AI May 1925 (11)*

40. A meeting of the board of directors of the *Z* Corporation was called to consider the issuance of bonds. *A*, one of the directors, did not attend but gave a proxy to *F* authorizing *F* to attend in his place. Was this proper and could *F* attend and act at the meeting? *AI May 1925 (10)*

41. A banking corporation had a charter giving its board of directors power to alter or to amend its by-laws. One by-law provided that no interest should be paid on certificates of deposit payable on demand. Interest was, however, paid upon such a certificate to *X*, whom the bank later sued for return of interest. *X* proved at the trial that he had obtained the written consent of a majority of the directors, one at a time, to such payment. What, in your opinion, should the trial judge have decided? *AI Nov. 1927 (8)*

42. Define what is meant by de facto officials of a corporation and the legality of their acts as officials. *NY June 1920 (6)*

43. *K*, *L* and *M* each owned one-third of the shares of capital stock of *C*, Inc. For many years each had participated equally in the distribution of profits. Subsequently, they disagreed and *L* and *M* refused to reelect *K* as a director, and at the same meeting *L* and *M*, by resolution, voted to pay themselves by way of salaries the profits the corporation had made.

(a) Was the last resolution valid? Explain.

(b) Would *L* and *M* be compelled to repay to the corporation the money so received?

Give reasons for your answer. *NY May 1930 (14)*; *NY May 1928 (14)*

44. Brown, a director of the *X* Realty Corporation, received from the *Y* Construction Company the sum of \$500 in payment for Brown's services in inducing the *X* Realty Corporation to award a certain contract to the *Y* Company. The *X* Realty Corporation afterward learned of the payment and sued Brown, seeking to recover the amount so paid to Brown by the *Y* Construction Company. Could the *X* Realty Corporation succeed? *AI May 1921 (10)*

45. *M* is appointed receiver of *A* Corporation. *M* sues *X* who had been a director of *A* Corporation to recover \$10,000 paid *X* by *K*. *X* in consideration of said payment resigned as a director of *A* Corporation and used his influence with the other directors to elect *K* a director. In whose favor will judgment be given? Give reasons. *NY May 1930 (12)*; *NY Nov. 1927 (12)*

46. A resolution of the *X* Corporation provided that all cheques should be signed by the treasurer and countersigned by the president or a director. By a series of ingenious excuses, the treasurer obtained the countersignature, by certain of the directors, of various cheques payable to "cash" or to "bearer." These cheques he misappropriated and turned to his own personal use. Upon discovery of the misappropriation, the corporation demanded that the directors involved make good the amounts lost. Could the directors be compelled to comply with the demand? *AI Nov. 1921 (11)*

47. In what circumstances are directors of a corporation authorized to declare dividends, and what are the liabilities of directors for declaring an unauthorized dividend? *AI Nov. 1920 (7)*

48. State generally the principal rights of a stockholder. *AI Nov. 1923 (10)*

49. How may the owner of a lost certificate of stock obtain a new one? *NY Jan. 1925 (13)*

50. How are shares of stock of a corporation transferred? *AI Nov. 1922 (11)*

51. You become secretary of a large corporation and, among other duties, have charge of all transfers of the corporation's stock. To safeguard the corporation, what formalities would you require with reference to each certificate presented for transfer? *AI May 1930 (5)*

52. The president and owner of one-half of the stock of a corporation executed, as president, a conveyance covering a large part of the property of the corporation in consideration of the other half of the outstanding stock, which was duly assigned to the corporation and was placed in its treasury. He failed to call a stockholders' meeting or to obtain the assent of 60% of them as required by the corporation's by-laws in case of a sale of capital assets or a purchase of treasury stock. Alleging that omission as grounds for their claim, the assignors of the stock who received the property now seek to have the transaction annulled. Will they succeed? *AI May 1931 (4)*

53. Ten individuals, constituting the entire number of stockholders of a Connecticut corporation, organized to conduct a general trading business having its principal place of business in the State of New York, and decided that it would be for their best interest to reorganize under the laws of New York and conduct the business within the state limits. The new corporation was duly or-

ganized and the by-laws of the company unanimously adopted as follows: "That no stockholder, either present or future, shall have the right to dispose of any shares of the capital stock of the company, in any manner, except by will, without first offering said shares for sale to this company."

The above by-law, having been unanimously adopted, became mutually binding upon the corporation and the members thereof; and therefore, to insure its observation, said by-law was printed in full upon the face of the certificates of stock issued by the new company in exchange for the old certificates surrendered under the terms of reorganization. At the close of their second fiscal year, a majority of the stockholders adopted, at the annual meeting, a resolution rescinding or repealing said by-law. The minority stockholders denied the right of the majority to so repeal the by-law. Is the latter resolution legally enforceable? *NY Jan. 1923 (13)*

54. Explain and illustrate the term *valuable consideration* as used in the law of contracts. *NY Jan. 1926 (4)*

55. The president and secretary of a mercantile corporation seal, execute and deliver in the company's name a mortgage on the company's real estate, without the authority of the directors. The company receives adequate value therefor. Can the holder foreclose in the case of default? Give reasons. *AI Nov. 1917 (11)*

56. When does a proxy executed by a stockholder of a corporation, which specified no time limit, become void? Must a proxy holder be a stockholder? *NY June 1922 (5)*

57. What is a voting trust and how does it operate? *AI May 1926 (7)*

58. Is the following agreement valid: A voting trust agreement signed by all the stockholders of a domestic stock corporation to a trustee named therein to vote their stock as trustee for fifteen years? Give reasons. *NY May 1929 (10)*

59. At a regular meeting of the Hickory Box Company, a majority of the stockholders resolve to make a radical change in the policy of the corporation. To this line of action the minority stockholders object strongly, believing it to be a dangerous course, although it is admitted that the proposed change does not involve the commission of any act of *ultra vires*. How can the minority stockholders prevent the change? Explain fully. *NY Jan. 1921 (12)*

60. At a regular meeting of the stockholders of a corporation, the majority resolves to alter radically the policy of the corporation. This appears dangerous to the minority, although it is admitted that the changes do not involve the commission of acts *ultra vires*. What can the minority do to prevent the change? Explain fully. *NY June 1916 (15)*

61. When the directors of a corporation have been so neglectful in the management of its affairs as to entail a serious loss to the

corporation, has a stockholder the right to bring suit against the directors for the amount lost by reason of their negligence? *NY May 1925 (11)*

62. How does a dividend paid by a corporation differ from a dividend paid by a trustee in bankruptcy? *NY Nov. 1926 (3)*

63. From what funds may dividends be paid and who determines whether and when they shall be paid? *AI Nov. 1919 (9)*

64. The XY Corporation is engaged in the real estate business. It owns a building, the cost of which was \$300,000. In July 1928, it sells the building for a price that nets it \$350,000. It then reinvests the proceeds of the sale in another building. Other than the profit on the sale, the corporation has only sufficient income to pay its operating expenses. Can the directors declare a dividend to the stockholders and, if so, by what means? *AI May 1929 (1)*

65. What right has a stockholder to a share of the profits of a corporate business? *AI Nov. 1918 (Corp 4)*

66. In January of each year for several years the directors of a corporation have declared an annual dividend on the company's preferred stock at the rate specified on the certificates. In the balance sheet of December 31st of each preceding year, the treasurer sets up the amount of the dividend as a liability of the company. Does the liability item correctly represent the company's responsibilities to its preferred shareholders and the holders of its notes payable? *AI May 1919 (8)*

67. A corporation had a deficit of \$40,000 at January 1, 1929. During that year it earned a net income from all sources amounting to \$35,000. In January 1930, the board of directors declared a dividend of \$10,000 out of the 1929 profits. Would this dividend have been legal in your state? *AI Nov. 1930 (4)*

68. You are elected a director of a corporation that has issued 6% preferred stock and also common stock. What information, other than the fact that there were earnings available, would you deem it necessary to have to vote properly on a resolution to declare a dividend on the common stock? *AI Nov. 1929 (4)*

69. The A.B. Corporation in the year 1921 made net profits of \$50,000, or sufficient for a dividend of 5% on its stock. No dividend was declared, however, and X, stockholder, sued the corporation for a sum equivalent to 5% on the stock held by him. Can he recover? *AI Nov. 1922 (10)*

70. X subscribed to an increase in the capital stock of the Monom Company and eventually paid in 40% of the contracted amount, meeting all installment calls promptly as made. The Monom Company soon thereafter declared a 6% dividend. Is X entitled to a dividend on his paid installments of the subscription? Explain. *NY Oct. 1933 (12)*

71. In what circumstances, if any, may a declared dividend be revoked and by whom must the revocation, if allowed, be made? *AI May 1931 (1)*

72. Has a stockholder a right to examine the books of a corporation? If so, for what purpose and under what conditions? *NY Nov. 1932 (4)*

73. What books are stock companies obliged by law to keep? What must the stock book show? Who, other than stockholders, may inspect and make extracts from the stock book? *NY June 1923 (3)*

74. What right, under the stock corporation law, has a minority stockholder to demand a financial statement from the corporation? *NY Jan. 1919 (15)*

75. What is the preference on the part of stockholders to subscribe to new shares upon increase of capital? *AI May 1918 (16)*

76. The Greystone Company was incorporated with authorized capital stock of \$25,000 (par value \$100 per share), of which \$20,000 was issued and outstanding. The directors of the Greystone Company adopted a resolution to sell the \$5000 unissued stock to *A* at par; *C*, a stockholder of the Greystone Company, demanded the right to subscribe at par to his proportionate share of the \$5000 of stock about to be sold. Thereafter the capital stock of the Greystone Company was increased to \$50,000 and the stockholders adopted a resolution to sell the \$25,000 of new stock to *F* at \$150 per share. *C* demanded the right to subscribe at par to his proportionate share of the \$25,000 of new stock. What are *C*'s rights as to (a) the \$5000 of stock, (b) the \$25,000 of stock? *NY June 1923 (12)*

77. The *X* Corporation increases its authorized capitalization from \$100,000 to \$200,000. Can the directors offer the increased stock for subscription to the public generally? *AI Nov. 1926 (11)*

78. A corporation has an authorized and issued capital stock of \$100,000. It increases its authorized capital stock to \$300,000. In what circumstances may the board of directors accept subscriptions to the new stock for cash at par from the public generally? *AI May 1920 (7)*

79. Each of the following paragraphs purports to summarize the law on the point involved. State as to each of them whether or not it is correct; if any one is incorrect, restate it; and in each instance give the legal reasons on which the rule is based:

(a) A stockholder has a pre-emptive right to participate ratably with other stockholders in subscribing for new shares when the corporation's capital stock is increased and new stock is issued.

(b) A stockholder has the same right with respect to authorized but unissued stock.

(c) A stockholder has the same right with respect to treasury stock acquired by the corporation with the intention of reissuing it.

(d) A stockholder has the same right with respect to treasury stock, acquired by the corporation with the intention of retiring it, that later is offered to investors. *AI May 1934 (3)*

80. The Steel Runway Corporation was capitalized at \$500,000: \$300,000 common stock, of which \$200,000 was issued, and \$200,000 preferred, all issued. By vote of the directors, subscription books were opened for the sale of common-stock shares to the present common stockholders ratably. X, a preferred stockholder, being refused permission to participate, brings suit urging his right to preserve his proportionate interest in the company. What holding, and why? *NY Nov. 1932 (12)*

81. On January 1, 1923, John Doe, the owner of 200 shares of the capital stock of the Second National Bank of Meadowville, transferred the stock to Richard Roe. New certificates of stock were promptly issued by the bank to Richard Roe, who receipted for them.

It was agreed between John Doe and Richard Roe that, if Richard Roe should be unable to sell the stock within six months from the date of transfer, John Doe would take the stock back.

Upon receiving the stock, Richard Roe signed a blank transfer with a power of attorney on the back of each certificate. In March 1923, Richard Roe handed the stock back to Doe, who pledged it with another bank to secure a loan to him on October 10, 1923.

The Second National Bank of Meadowville became insolvent and a receiver was appointed to wind up its affairs. Realizing that he had neglected to have the stock transferred to Doe, Richard Roe brought an action to enjoin the receiver from enforcing any personal liability against him on the stock in question. The receiver made counterclaim for the amount of assessment that had been levied on the stock of the bank in order to pay creditors. Richard Roe denied all liability on the ground that he had never purchased the stock from Doe. Is Richard Roe liable for the assessment claimed by the receiver? *NY Jan. 1924 (1)*

82. What is the liability of a stockholder of no-par stock of a domestic corporation (a) to the corporation, (b) to creditors of the corporation? *NY May 1929 (6)*

83. State the liability, to judgment-creditors, of the stockholders of a corporation having par value stock, and of the stockholders of a corporation having no-par-value stock. State also the liability of stockholders in each of the said corporations to employees of the corporation for wages and salaries unpaid by the corporation. *NY May 1926 (7)*

84. Is the agreement between the shareholder and the corporation that all shares shall be deemed fully paid up effectual as against creditors? Explain. *AI May 1918 (15)*

85. The Basswood Furniture Company was organized for the manufacture and sale of furniture. Subsequent to the organization

of the company, Hurd subscribed for 50 shares of the stock but failed to pay any part of his subscription. Later on, the corporation became insolvent and the creditors endeavored to recover from Hurd the amount of his subscription. Was he liable? Give reasons. *NY Jan. 1921 (11)*

86. A and B, upon the formation of a corporation, agreed to take certain shares of the corporation's stock. They paid one-fourth of the purchase price (that is, one-fourth of the par value of the stock that it was agreed should be purchased) but failed to make any further payments. The corporation, after conducting business for a time, became insolvent, and the creditors, finding that the corporation had no assets, sued A and B for the balance of the purchase price of the stock that they agreed to purchase. Did the creditors recover? *AI Nov. 1923 (11)*

87. The owner of a business sells all the assets of the business to a corporation. Nothing is said about liabilities, and the corporation has no notice or knowledge of debts that the business owes. Have the creditors of the old business any redress against the corporation? Explain. *NY Jan. 1917 (12)*

88. A foreign corporation desires to hold property in New York. From whom should it obtain the right to do business in this state? What is the effect on contracts if the right is not obtained? *NY Nov. 1934 (13)*

89. A corporation is formed in Delaware that is empowered by its charter or certificate of incorporation to do business in all states of the United States. Specify what steps in general should be taken by the corporation before operating in states other than Delaware and what would be the result, if any, of failure to take such steps? *AI May 1922 (10)*

90. The Jefferson Plan Corporation was a Delaware corporation having its executive office in Philadelphia, Pa. One of its vice presidents was served with a summons in Trenton, N.J. The corporation had not procured a permit to do business in New Jersey. It appeared that the vice president who was served with the summons had an office in Trenton in which he devoted his time to research work on matters affecting the Jefferson Plan Corporation, to the editing of printed literature for that corporation, and to the training of employees for it. Do these facts constitute doing business within New Jersey to such an extent as to give the courts of that state jurisdiction of the Jefferson Plan Corporation? *AI May 1933 (9)*

91. The X Company, of Pennsylvania, manufactures articles and merchandise used all over the United States. Its business in Massachusetts was handled through the A Company, a large jobbing house, which purchased from the X Company in Pennsylvania and resold to retailers in Massachusetts. The X Company maintained

no office in Massachusetts, was never licensed to do business in Massachusetts and paid no taxes to that state. Four times a year, salesmen from the home office of the X Company canvassed the retail trade in Massachusetts, educating the trade in the use of the X Company's products and taking orders. Such orders were immediately turned over to the A Company by the salesmen, the A Company filling the orders from its own stock, purchased from the X Company. The State of Massachusetts levied taxes against the X Company on the business thus done and added heavy penalties on the ground that the X Company was doing business in Massachusetts without having obtained the necessary license. Was the state successful in collecting? *AI May 1924 (11)*

92. Under what conditions may a foreign corporation, other than a moneyed corporation, doing business in this state maintain any action in this state upon any contract made by it in this state? *NY Nov. 1928 (4)*

93. Name some powers impliedly conferred on every corporation. *AI Nov. 1918 (Corp 1)*

94. A corporation is formed for the purpose of manufacturing, buying, selling and dealing in drugs, chemicals and similar products. The corporation, under authority of its board of directors, contracts to purchase the land and building occupied by it as a factory and store. G, a stockholder, sues in equity to restrain the corporation from completing the contract, claiming that, as the certificate of incorporation contained no provision authorizing the corporation to purchase real estate, the contract was *ultra vires*. Was G's claim correct? *AI Nov. 1926 (7)*

95. Name some corporate powers that will not be implied. *AI Nov. 1918 (Corp 2)*

96. The XY Corporation is engaged in the grocery business in the city of Harrisburg, Pennsylvania. Its directors, by a resolution duly adopted, authorized the officers to enter into a copartnership agreement with W with the object of operating a grocery store in Philadelphia, W to supervise the running of the store and to furnish some capital, the corporation to furnish the balance of the necessary capital and to attend to the buying of all stock. The agreement was adopted. Was it a valid agreement? *AI May 1923 (11)*

97. Under what conditions may a corporation become the owner of its own capital stock? *AI May 1918 (13)*

98. Has a corporation, without express statutory authority to do so, the power to purchase and hold the stock of another corporation, assuming, of course, that there is no statute expressly prohibiting the corporation from doing this? *AI May 1928 (9)*

99. Explain what is meant by *ultra vires* in regard to the act of a corporation and give an example of such an act. *NY June 1932 (11)*

100. (a) Define *ultra vires* as used in the law with respect to corporations.

(b) Give an example of an *ultra vires* act. *AI Nov. 1934 (3)*

101. X insured certain buildings owned by him with Y Fire Insurance Company against damage by windstorm or tornado, paying the required premium therefor. While the policy was in force, the buildings were damaged by wind. When X sought to recover the amount of his damages, the company contended as a defense that the wind-or-tornado insurance was not within the scope of its charter powers and that the policy was therefore void. Was such defense good? *AI May 1927 (9)*

102. How far are by-laws binding upon strangers:

(a) When they have no notice of them?

(b) When they have notice of them? *AI June 1917 (16)*

103. The president of a corporation had power under the by-laws to appoint, to remove and to fix the compensation of employees. Without express authorization from or ratification by the board of directors he made a contract with Jones whereby the corporation was to employ Jones for life. Was this contract binding upon the corporation? *AI May 1934 (7)*

104. The by-laws of a corporation provide that the treasurer or, in his absence, the president or vice president shall sign checks, notes, etc., for the company. A note for \$10,000 is made out by the company to itself and indorsed in blank. Albert Smith, who is both secretary and treasurer, signs the note: "The X Company: By Albert Smith, Secretary."

The note is negotiated at the bank by the company but, on maturity, the corporation refuses to pay on the ground that the note is not signed properly.

What holding and why? *NY Oct. 1933 (13)*

105. The by-laws of X business corporation provide that the manager shall not have power to contract a debt in excess of \$1000 without a vote of the board of directors. B, the manager, has been for several years in active charge of the business of the corporation and has bought from time to time, from the Y Company, goods used in the business of the X Corporation for amounts varying between \$10 and \$1000. He now orders a bill of goods amounting to \$1500, and the X Corporation refuses either to receive or to pay for the goods. Is it liable? *AI May 1920 (8)*

106. Distinguish between merger and consolidation as provided for in the corporation laws of the State of New York. *NY May 1926 (6)*

107. Mention *three* ways or means by which a corporation's existence may be terminated. *NY Nov. 1934 (15)*

108. In what ways or by what means can the existence of a corporation come to an end? *AI Nov. 1931 (6)*

109. Who may move for a voluntary dissolution of a corporation? Under what circumstances may such proceedings be instituted? To whom is the petition presented? *NY June 1923 (6)*; *NY June 1921 (7)*

110. A corporation that was in financial difficulties determined to cease business. It proceeded to sell certain assets, the proceeds of which were distributed pro rata among the stockholders as a dividend in liquidation. Later, on the petition of the creditors, the corporation was declared bankrupt, and the trustee in bankruptcy brought suit against the stockholders to recover the amounts distributed to them. Were the trustee's suits successful? *AI May 1923 (12)*

111. State the requirements of the stock-corporation law with reference to the annual report of corporations to the Secretary of State, (a) as to the time when the report is to be made, (b) as to the contents of the report.¹¹⁶ *NY Jan. 1916 (12)*

112. A certificate of incorporation was filed at Albany in the proper office, in which certificate it is provided that the corporation is organized for the purpose of manufacturing and selling wine. Does this invalidate the incorporation, or not? (For the purpose of answering this question, you may assume that the formalities as to filing, payment of fees, and so on, are fully complied with.)¹¹⁷ *NY June 1924 (14)*

¹¹⁶ Obsolete. Section 34 of the New York Stock Corporation Law, which provided for an annual report of stock corporations to the Secretary of State, has been repealed and the requirements of this statute are no longer operative.

¹¹⁷ Obsolete. At the time this question was framed (1924) the Eighteenth Amendment and the Volstead Act (prohibiting the manufacture and sale of alcoholic beverages) were in effect. They have since been repealed.

CHAPTER IX

Guaranty and Suretyship

902. **Scope of chapter.** In this chapter we consider the nature and purpose of suretyship; the different types of suretyship, and the respects in which suretyship may be distinguished from guaranty, indemnity, indorsement and warranty; the contract of suretyship, and its special requisites; suretyship and the statute of frauds; the various defenses, and likewise the various remedies available to a surety; and a brief summary of the different types of surety business and of surety bonds.

A. Nature and Purpose: Definitions and Distinctions

903. **Nature and purpose.** A guaranty or suretyship consists of a promise to make good another's obligation. Its purpose is to add one's credit to that of another.

Contracts involved. Every guaranty or suretyship involves two contracts. The first, or *principal contract*, is the one secured; the second, which secures the first, is the contract of guaranty or suretyship. It is a *contingent* or *collateral* contract, that is, it does not become effective unless the first contract is breached or defaulted.

Parties involved. Every guaranty or suretyship involves at least three parties. In the principal contract, creating the primary obligation, the primary or *principal debtor* or *obligor* becomes obligated to a *creditor* or *obligee*. In the secondary contract, creating the guaranty or suretyship, the secondary debtor, known as a *guarantor* or *surety*, promises the creditor to make good upon the principal debtor's default.

Promise to pay v. promise to answer for. A promise to pay the creditor for some benefit bestowed on another creates but one contract. To create a guaranty or suretyship there must be a promise to *answer for* another.

Examples:

(1) Jones writes Smith: "Deliver the following merchandise to Brown, and send me the bill." This involves but a single promise to pay, and creates but a single contract (for Brown's benefit), wherein Jones is debtor and Smith creditor.

(2) Jones writes Smith: "Deliver the following merchandise requested

by Brown, and *if he does not pay, I will.*" This involves a promise to answer for another. It creates, first, a *principal contract* (between Smith and Brown), and secondly, a contract of guaranty or suretyship, wherein Jones agrees to answer for Brown, that is, to pay Smith *if Brown defaults*.

904. Guaranty and suretyship: defined and distinguished. In substance, guaranty and suretyship are one and the same. Both involve obligations to answer for the debt, default or miscarriage of another. Debt refers to money obligation, default to breach of contract obligation, and miscarriage to breach of some duty, as where one promises to make good for another's negligence, embezzlement, and so on.

In practice, the words "guaranty" and "suretyship" are used interchangeably, not only by laymen, but by lawyers and courts as well. However, certain technical distinctions are sometimes made between suretyship and guaranty:

(a) *Time when obligation accrues.* A surety becomes liable simultaneously with his principal, upon the same undertaking, the same consideration, and usually the same instrument, whereas a guarantor becomes liable at a different time from that which marks the origin of the principal's liability, and likewise by a different instrument and often upon a separate consideration from that on which the principal is bound. Principal and surety, in other words, are usually bound on the same identical contract, and the surety is thus definitely obligated from the start; whereas the guarantor's undertaking is separate and collateral, and the liability assumed by it does not come into actual existence unless and until the principal defaults.

(b) *Necessity of notice.* A surety, being obligated on the same undertaking with the principal, is chargeable with knowledge of the principal's default, and is therefore liable without notice immediately upon such default, as in the case of a surety bond on which *both* principal and surety are jointly and severally "held and firmly bound." A guarantor is usually entitled to notice of the principal's default.

(Except where otherwise noted, we shall use the words "guaranty" and "suretyship" interchangeably throughout the remainder of this chapter.)

905. Guaranty of collection *v.* guaranty of payment. A *guarantor of collection* virtually says, "I will pay if the principal debtor *cannot*." Before the creditor can hold a guarantor of collection, therefore, he must show that the principal *cannot pay*; that is, he must first exhaust his legal remedies against the principal. A *guarantor of payment*, however, says in effect, "I will pay if the principal debtor *does not*." His liability

is fixed when the debt is due and the principal *does not* pay, regardless of his ability or inability to pay.

906. *Guaranty v. indemnity.* The object of a contract of guaranty is to induce the extension of credit. The object of an indemnity agreement is to assume, for a money consideration, the risk of loss if credit is extended. A contract of guaranty is a promise to make good a specific debt or default. A contract of indemnity, however, is an undertaking, for a given consideration, to *save a person harmless* in respect to dealings, past, present, or contemplated, with some other person. It is not, as in guaranty, a promise to answer for the default of such other person, but rather an undertaking to make good any losses incurred by the creditor in dealing with such person. The consideration that the indemnitor gets is some money or other benefit paid by the creditor to the indemnitor for assuming the risk, not, as in the case of guaranty, *the mere act itself*, or creditor's sacrifice, *in extending the credit*. If the indemnitor pays a loss, he does so, not on account of the debtor's default, but on account of his own separate obligation (for which he has been paid) to assume the risk of losses. Hence, if a loss occurs, the indemnitor has no recourse against the debtor for reimbursement, unless so expressly agreed; whereas if a guarantor pays the principal debtor's obligation, he may proceed against the principal debtor for reimbursement.

907. *Guaranty v. indorsement.* The chief difference between the position of a guarantor of negotiable paper and that of an indorser is that the obligations of the former are governed by the general law of contracts; whereas the obligations of an indorser are governed by the special conditions, limitations and requirements of the law merchant, such as presentment for payment, notice of dishonor, and so on.

Example: A guarantor may become liable on the principal's default with or without notice, depending on the contract of guaranty. Even where notice is required, it will be sufficient if given within a reasonable time or within the period stipulated by the contract of guaranty, if any. However, an indorser is liable only in case notice of dishonor is given to him within the time required by law (sec. 357).

908. *Absolute v. conditional guaranty.* An *absolute* guaranty is an out-and-out promise to make good another's debt or default, without condition or limitation; for example, a flat

guaranty on a lease to make good a tenant's default. A *conditional* guaranty is one wherein some condition must first be performed by the creditor before the guarantor is liable; for example, the guaranty of a series of purchases upon condition that with each purchase a sworn statement of bank balances be furnished in duplicate, one for the creditor and one for the surety. Unless such condition is complied with in each instance, the guarantor is not liable.¹

909. Single *v.* continuing guaranty. A *single* guaranty is one limited to a single transaction.

Example: I promise to answer for your payment of a \$2000 automobile. You buy a \$1900 automobile. Though my risk is lessened, my obligation is varied: I am not liable.

A *continuing* guaranty is one that is not limited to a single transaction but covers a succession of liabilities for which, as and when they accrue, the guarantor becomes liable.

Example: I promise a dealer to answer for your obligations in buying automobile accessories "up to" \$1000, or "not exceeding" \$1000. The language in both instances implies a continuing guaranty covering any liabilities from \$1 up to \$1000.

910. General *v.* special guaranty. A *general* guaranty is one addressed to no particular person but to the world at large, such as, "To whom it may concern." Such a guaranty may be enforced by anyone to whom it is presented and who acts on it. A *special* guaranty is one addressed to a particular person, who alone can take advantage of it and to whom alone the guarantor is liable.

911. Guaranty *v.* warranty. Although the terms *guaranty* and *warranty* are used interchangeably in a loose sense, they are, strictly speaking, distinguishable. A guaranty is an undertaking to answer for the default of another. A warranty, ordinarily, relates to one's own obligation. It is "an undertaking that the title, quality, or quantity of the subject matter of a contract is what it has been represented to be."²

B. The Contract of Suretyship

912. Characteristics and requisites of suretyship contract. A suretyship contract differs from an ordinary contract in that it depends for its existence on another or principal contract. If

¹ *Yama v. Sigman*, 114 Colo. 323, 165 P. 2d 191.

² 38 *Corpus Juris Secundum* 1134.

the principal contract is void, or is performed, or is varied without the surety's consent (sec. 926), the contract of suretyship is void or extinguished. Moreover, suretyship always arises out of an express contract. Unlike many other obligations, the obligation of suretyship is never implied by law. Also, as we shall see, if the contract is *really* one of suretyship, it must be created by a *signed promise in writing*.

As with all contracts, a suretyship contract must have the usual contract requisites: Parties having contractual capacity, mutual assent, consideration, and valid subject matter.

913. Parties. An infant's contract of suretyship is voidable, not void. We have already noted the limitation on a partner's right to bind his firm by contracts of guaranty and suretyship (sec. 682), and also that a corporation may not bind itself by a contract of suretyship except in furtherance of express or implied powers to engage in such contracts (sec. 882).

914. Mutual assent. The rules governing mutual assent, already considered (secs. 107-135) in the chapter on Contracts, apply to contracts of guaranty and suretyship, as they do to all contracts. An offer to guarantee a contract upon a given condition can be accepted only upon such condition.

Example: Danver offers to guarantee Reid's undertaking to Pawling upon the condition (expressed in the contract, hence known to Pawling) that Taylor is to be cosurety. Reid delivers the contract of guaranty to Pawling with Danver's but without Taylor's signature. Failure to obtain Taylor's signature constitutes a good defense to Danver's liability.

Likewise, if the surety's contract was procured through fraud or concealment, he has a good defense.³

915. Consideration. As pointed out (sec. 146) in the chapter on Contracts, consideration need not benefit the promissor, so long as it represents a *sacrifice* to the promisee. In a contract of guaranty or suretyship, the promisee (creditor), by the sacrifice of extending or agreeing to extend credit to the principal debtor, supplies consideration to bind the promise of the guarantor or surety, though the latter may not be benefited by the extension of credit. But if the surety's promise is given *after* the credit has been extended, it is based on *past consideration* and is not binding, with the following exceptions: (a) In some states (sec. 150) a *written* promise based on past consideration is binding; (b) where the past consideration is

³ *Jungk v. Holbrook*, 15 Utah 198, 49 Pac. 305.

coupled with future consideration, such as forbearance to sue, it will support the guarantor's promise, provided the promise is in writing, as it must be under the statute of frauds (secs. 185 and 917.)

Examples:

(1) A firm of public accountants made an agreement with a corporation by its president to examine its books. After the examination had begun, the accountants refused to continue unless the president personally guaranteed that they would be paid. This he agreed to do. After the accountants completed their work, they demanded payment of the president personally, the corporation having become insolvent. Such payment could not be enforced if the president's promise was oral. (See sec. 921, "Example of indirect benefit.") If it was in writing, it could be enforced in New York and in other states where the statute provides that a written promise based on past consideration is binding; otherwise not.

(2) If the president's promise had been made after the work was completed and in consideration of a promise by the accountants to forbear suit against the corporation, it would have been enforceable provided it was in writing.

(3) See secs. 1690-1693.

916. Subject matter. The subject matter of a contract of guaranty or suretyship is *the principal contract that it guarantees*. If the principal contract is void, so is the secondary one, that is, the suretyship contract. If the principal contract is merely voidable (for example, if the principal is an infant), the secondary contract is nonetheless binding.

Examples:

(1) If X guarantees A's promise to pay for merchandise at black market prices, the illegality of the principal contract renders the contract of suretyship illegal.

(2) But if X guarantees the legitimate obligation of B, an infant, he is liable notwithstanding B's infancy. Such infancy does not render the principal contract void for illegality, but voidable for incompetency.

C. Suretyship and the Statute of Frauds

917. General rule. The statute of frauds provides that a special promise to answer for the debt, default or miscarriage of another must be in writing or it is not enforceable. But the promise must be strictly one of suretyship or the rule will not apply. There must be a principal debtor who remains primarily liable and a promise made by one person to another to answer for a third party. As noted in sec. 185, a promise to *pay* for another, as distinguished from a promise to *answer for*

another, is binding, though oral. Transactions resembling but not actually constituting suretyships are enforceable, though not evidenced by a writing. In each of the situations set forth in secs. 918 to 922 following, there is no real or unqualified suretyship, and the promise is binding, though oral.

918. Indemnity agreements. As noted in sec. 906, an indemnity agreement is not, strictly speaking, an agreement to answer for another's obligation, but to hold a person harmless in respect to his dealings with another. The object is to assume a risk, usually for a consideration. An indemnity agreement is therefore an original, not a collateral, undertaking. Although there is a conflict of authority as to whether contracts of indemnity must be in writing, such conflict arises from the fact that in some situations a contract purporting to indemnify is really an undertaking to answer for the debt of another, hence subject to the statute of frauds, whereas in other cases the indemnity agreement is truly an original undertaking, hence not subject to the statute. Where the main object of the indemnity is not to answer for another, but to benefit the indemnitor, the indemnity is an original agreement, and no writing is essential to its validity.⁴

Example: A promise by a bank depositor to reimburse a fellow depositor if he suffers any loss by not withdrawing his funds from the bank has been held to be a promise to answer for another, hence void unless in writing;⁵ but a similar promise made by an officer of the bank for his own interest has been held to be an original undertaking, hence valid though not in writing.⁶

919. Promise not made to creditor. Frequently, indemnity agreements take the form of promises to hold some person harmless, other than the creditor. Such promises are not agreements to answer for another, but original undertakings, binding though oral.

Examples:

(1) If I encourage you to contract a debt and orally promise *you* (not the creditor) that I will back you up financially if you default, there is no suretyship; my promise is binding.

(2) See sec. 1694.

⁴ *New York Guarantee Trust Co. v. Koehler*, 195 F. 669, 115 C.C.A. 475, reversing C.C., 187 F. 192.

⁵ *Trento v. De Benedetti*, 283 Ill. App. 182.

⁶ *Dillard v. Walker*, 204 N.C. 16, 167 S.E. 636.

920. Promissor already obligated. Where one is already obligated by law to pay a debt or discharge a duty on behalf of another, a promise to make good such obligation amounts to an original, not a collateral, undertaking, or guaranty, and hence is binding though oral.⁷

Examples:

(1) Where A and B are jointly obligated to C, a guaranty by A of B's performance need not be in writing.

(2) Where a workmen's compensation law requires an employer to provide medical attendance for an injured employee, the employer's guaranty of payment for such medical attendance is not governed by the statute of frauds.⁸

(3) An oral guaranty by a partner, or by the firm, of the payment of a debt for which the partnership is liable, anyway, is not within the statute of frauds.

921. Benefit to promissor. Where the promise to answer for another is largely or even partly for the promissor's own benefit, the promise is more in the nature of an original undertaking, and is binding though oral.⁹ The benefit to the promissor, however, must be direct, not indirect; if the latter, the undertaking is collateral, not original, and must be in writing.

Example of direct benefit: promise binding, though oral. The promise of a *del credere* agent to make good the debts of his customers. (See sec. 545 subd. (i).)

Example of indirect benefit: promise not binding, if oral. A stockholder's or officer's oral guaranty of a corporate debt, where the corporation continues as the principal debtor. (See secs. 1691, 1695 and 1858.)

922. Novation. Where the promise constitutes a novation (sec. 212), it is not really a guaranty; the promissor merely takes the place of the original debtor. Such a promise is binding though oral.¹⁰

⁷ *Coonse & Caylor Ice Co. v. Home Stove Co.*, 70 Ind. App. 226, 121 N.E. 293; *Platte Valley Drainage Dist. of Worth County v. National Surety Co.*, 221 Mo. App. 898, 295 S.W. 1083, 1089.

⁸ *Beekman v. Claman*, 155 Misc. 593, 280 N.Y. Supp. 75.

⁹ *Lesser-Goldman Cotton Co. v. Merchants' & Planters' Bank*, 182 Ark. 150, 30 S.W. 2d 215, 217; *Sadd v. Siegelbaum*, 124 Conn. 383, 200 A. 346, 347; *Darby v. Saffold & Sharpe*, 49 Ga. App. 81, 174 S.E. 250; *Horning v. Moyer*, 96 Ind. App. 374, 185 N.E. 303; *Cole & Moore v. Aetna Casualty & Insurance Co.*, 280 Ky. 757, 134 S.W. 2d 639, 643; *Gardiner v. Cleveland Motors*, La. App., 16 So. 2d 544; *Palmer v. Bridges*, 151 Miss. 12, 117 So. 328; *Bean v. Tripp*, 99 Or. 216, 195 P. 355; *Irwin, Keelan & Sterck v. Tracy*, 294 Pa. 503, 144 A. 525; *Dyson v. Moore*, (Tex. Civ. App.), 78 S.W. 2d 285.

¹⁰ *Waters v. Blackmon*, 228 Ala. 462, 153 So. 739; *Carr-Lee Grocery Co. v. Brannen*, 46 Ga. App. 225, 167 S.E. 536; *McCord-Brady Co. v. Hagan*, 124 Kan.

Examples:

(1) My promise to assume Brown's debt to you in consideration of your releasing Brown would be binding though oral.

(2) An oral promise by a sole or controlling stockholder to answer for the corporation's debt would be binding if it was the intention of the parties that the stockholder was to become the principal debtor.¹¹

D. Suretyship Defenses: Acts Discharging Surety

923. Suretyship defenses: in general. A surety is said to have a defense if he has good ground for disclaiming liability. The defenses available to a surety fall into four classes:

- (1) Defenses based on infirmity of the surety's contract.
- (2) Defenses based on infirmity of the principal contract.
- (3) Defenses based on varying the surety's risk.
- (4) Defenses based on discharge.

924. Infirmity of surety's contract. If the contract of suretyship is itself defective, either as to form or requisites, no liability arises. The requirements as to form under the statute of frauds have already been considered in secs. 917 to 922. The contract requisites as they apply particularly to suretyship and guaranty are discussed in secs. 913 to 916.

925. Infirmity of principal contract. As noted in sec. 916, if the principal contract is void, the suretyship contract is void for illegal subject matter; but if the principal contract is merely voidable, the suretyship contract is nonetheless binding, unless such voidability is due to the creditor's misconduct.

Example: A surety for an infant principal is not relieved of liability if the infant disaffirms, but if the principal successfully avoids liability because of the creditor's fraud, or duress, the surety is likewise relieved of liability for the same cause.

926. Varying the surety's risk. A surety is said to be a favorite of the law. His liability is *strictissimi juris*: Strictly limited to the letter of his obligation. By this is meant, not that he is entitled to favored or preferential consideration, but that, inasmuch as he has assumed a liability without benefit to himself, such liability must be strictly or literally construed.

319, 259 P. 785; *Kushner v. Knopf*, 227 Ky. 369, 13 S.W. 2d 271; *Colpitts v. L. C. Fisher Co.*, 289 Mass. 232, 193 N.E. 833; *True-Hixon Lumber Co. v. McDonough*, 154 Miss. 720, 123 So. 855; *Tannhauser v. Shea*, 88 Mont. 562, 295 P. 268; *Leach v. Nelson*, 48 N.D. 1046, 189 N.W. 251; *Denton v. Kennedy*, 121 Okl. 161, 249 P. 291; *F. I. Somers & Sons v. Le Clerc*, 110 Vt. 408, 8 A. 2d 663; *Smaby v. Shrauger*, 9 Wash. 2d 691, 115 P. 2d 967.

¹¹ *Bulkeley v. Shaw*, 289 N.Y. 133.

Consequently, a surety has a right to insist on strict performance of the contract that he has guaranteed. Any variance without the surety's consent, whether detrimental to the surety or not, discharges him. Examples of such variances are:

(a) *Variance in parties.* A guarantees performance by B. The contract is actually performed by B and Company. A is discharged.

(b) *Variance in extent of principal's commitment.* A tenant leases part of a building. The lease is guaranteed by X. Later, without X's knowledge or consent, the tenant obtains the rest of the building at an additional rental. X is discharged from all liability.

(c) *Variance in amount, place, time or manner of making payments.* A sues B for breach of B's contract obligation requiring ten equal monthly payments of \$100 each to A, at A's office, none of which were paid. The contract is guaranteed by X. Upon the trial, the case is settled for \$800 by stipulation requiring four payments of \$200 each at the office of A's attorney. X is discharged.

(d) *Change in duties of principal.*¹² A surety for an agent who is to make sales only is not liable after authority is given to the agent to make collections also.¹³

(e) *Surrender of security.* X guarantees A's debt to B in the amount of \$10,000, secured by a \$10,000 mortgage on A's house. Upon A's request, without X's consent, B surrenders the mortgage to A.

(f) *Change of security.* If, in the previous example, B, without X's consent, exchanges the mortgage for other security, the result is the same: X is discharged.

(g) *Taking additional security.* If, in Example (e), B took additional security without modifying the existing debt and mortgage, the surety would not be released; but if such additional security affected the surety's risk in any way, as by extending the time of payment, the surety would be discharged.

(h) *Taking note for debt.* Where the creditor, without the surety's acquiescence, takes a note for an existing debt, the surety's liability on the guaranteed debt depends upon whether the debt was in any way affected by the note. (See sec. 1699.)

(i) *Change beneficial to principal debtor.* It is not necessary that the variance be prejudicial to the surety in order that he be discharged. The surety may be discharged even where the change was beneficial to the principal debtor. (See sec. 1697.)

927. Defenses based on discharge. A surety may disclaim liability not only where the contract, his own or the principal's, is ineffective or where the principal contract has been varied without the surety's consent, but also where some act in and

¹² *Fidelity Mut. L. Assoc. v. Dewey*, 83 Minn. 389, 86 N.W. 423.

¹³ *Tradesmen's Nat. Bank v. National Surety Co.*, 169 N.Y. 563.

of itself, such as performance or release of the obligation, spells out a discharge.

(a) *Performance* by the principal debtor automatically releases the surety.

(b) *Release of the surety* by the creditor naturally discharges the surety.

(c) *Release of the principal debtor* by the creditor likewise discharges the surety, since the creditor cannot excuse performance on the one hand and insist on responsibility for nonperformance on the other. (See sec. 1702, subd. (a).)

Voluntary v. involuntary release. To discharge the surety, a release of the principal debtor must be voluntary. If it is involuntary, as in the case of a release by operation of law, it will not discharge the surety.

Example: A discharge in bankruptcy, being involuntary (as to the creditor), will not discharge the surety, but a composition agreement, being voluntary, will. See sec. 1702, subds. (b) and (c).

Qualified release: reservation of rights against surety. A creditor in discharging the principal debtor may expressly reserve all his remedies against the surety, "in which case the latter will be in a position to pay immediately and, then, to proceed against the principal debtor."¹⁴

Release v. suspension of remedy. Where the creditor's remedy against the principal debtor is suspended by operation of law (as in the case of war between the creditor's and the debtor's countries), the surety is not thereby discharged. See sec. 1703, subd. (b).

(d) *Death or insolvency.* A surety is not discharged by the death or insolvency of the principal. Neither will the death of a surety release his estate from obligations incurred up to the date of his death. As to unmat-ured, contingent obligations that might arise under the surety's contract after his death, the liability of the estate will depend upon whether or not the suretyship contract was revocable at the surety's option during his lifetime. (See sec. 1700, subd. a.)

928. Delay by creditor in proceeding against principal. Ordinarily, mere delay by a creditor in pursuing his remedies against the principal will not discharge the surety, because the surety, if he fears for the future solvency of the principal, may always protect himself by stepping forward and promptly paying the debt himself. He is then in a position himself to turn around and hold the principal debtor forthwith. However, in some cases a surety's obligation is conditioned on an express

¹⁴ *National Park Bank v. Koehler*, 204 N.Y. 174, 179-180. See also, *Schwitzerlet-Seigler Co. v. Citizens, etc., Bank*, 155 Ga. 740, 118 S.E. 365; *Mueller v. Dobschuetz*, 89 Ill. 176; *Clagett v. Salmon*, (Md.), 5 Gill. & J. 314; *Potter v. Green*, (Mass.), 6 Allen 442; *Boatmen's Sav. Bank v. Johnson*, 24 Mo. A. 316; *Stirewalt v. Martin*, 84 N.C. 4; *Weddington v. Jones*, 41 Tex. Civ. App. 463, 91 S.W. 818; *Brown v. Vermont Mut. F. Ins. Co.*, 83 Vt. 161, 74 A. 1061.

or implied obligation by the creditor to proceed against the principal debtor promptly upon default; and in such cases, if the creditor fails to act promptly and the surety is unable to hold the principal debtor because of the delay, the surety will be discharged.

E. Remedies of Surety

929. Remedies v. defenses. The *remedies* of a surety, as distinguished from his *defenses*, deal with his efforts to relieve himself of the burdens of suretyship, not by *denying* the obligation but by seeking to *shift its burden*, in whole or in part. A surety's principal remedies are (1) subrogation, (2) indemnification, (3) exoneration and (4) contribution.

930. Subrogation. To "subrogate" is, literally, to substitute one person in the place of another. If the principal debtor's obligation to the creditor is in any way protected by security, either by the deposit of collateral or by a lien on the principal debtor's property, the guarantor, upon discharging the principal debtor's obligation, is entitled in equity to have the security transferred from the creditor to himself, because in discharging the principal debtor's obligation, the guarantor becomes "subrogated" to all the rights of the creditor against the principal debtor. This is what is meant by the expression, "The guarantor steps into the creditor's shoes." (For an example, see sec. 1705.)

931. Reimbursement or indemnity. Unless a surety pays the *entire debt* owed by the principal debtor to the creditor, he is not entitled to the equitable remedy of subrogation; that is, he has no equitable claim against the collateral or lien held by the creditor to secure the debt. However, the law raises an implied promise on the part of the principal debtor to indemnify the surety or guarantor to the extent of his loss in making good the principal debtor's obligation. Surety companies make it a practice, before issuing a bond, to require the principal debtor to execute a specific agreement indemnifying the surety company against loss in assuming the risk. Under the remedy of *indemnification*, if a guarantor pays only a *part* of the principal debtor's obligation, he is entitled to sue the principal debtor at *common law* (not in equity) for recovery of the amount of money that he has actually paid the creditor for the principal debtor's benefit.

932. Exoneration. To exonerate a person is to relieve him from a burden. Where the principal debt has matured, the surety may bring an action in equity to compel the principal to pay the debt. "The jurisdiction in this class of cases rests upon the fact that there is a debt due which it is the duty of the principal debtor, in exoneration of his sureties, to pay forthwith."¹⁵

933. Contribution. Where there are two or more sureties, and only one of them makes good the default, he may compel contribution from his cosureties. Where two or more guarantors are jointly and severally obligated on a guaranty, each guarantor, upon paying more than *his proportionate share* of the guaranty, may compel the coguarantor or coguarantors to contribute their respective shares *of the excess*, "but in no case can the surety seeking contribution recover more than the excess he has paid beyond the amount which, as between himself and the cosureties, it was his duty to pay."¹⁶

Example: Suppose Brown, Smith and Black are coguarantors on a \$3000 principal obligation. If Brown makes good \$1000 out of the principal amount, he can recover no contribution from Smith or Black, because \$1000 is his ratable liability in any event. But if he pays \$2000, he can compel contribution of \$1000, or the excess over his proportionate share of the guaranty, from Smith and Black; and if he has paid the entire principal amount, he can compel Smith and Brown to contribute \$2000, or the amount of the excess over his own ratable liability.

F. Surety Bonds

934. Definition. A *bond* is the formal acknowledgment of an obligation, usually under seal. A *surety bond* acknowledges an obligation to make good the performance by another of some act or duty. The person who executes the bond is known as the *obligor*, corresponding to the *surety*, and the person to whom the obligation is incurred is known as the *obligee*, corresponding to the *creditor*.

935. Single bond v. bond with condition: surety bonds. A *single bond* simply acknowledges indebtedness, without reciting any condition that might extinguish the indebtedness. A *bond with a condition* acknowledges an obligation in a specified sum and then recites a condition that may extinguish the liability. A surety bond is a bond with a condition. It usually

¹⁵ *Holcombe v. Fetter*, 70 N.J. Eq. 300, 301.

¹⁶ 50 *Corpus Juris* 298.

takes the form of a conditional acknowledgment of indebtedness. First, in the "preamble," it recites the terms of the principal contract and the principal duty or principal obligation secured. Then, in the "obligatory" part, it acknowledges the "penal sum" in which the obligor, his heirs, representatives and assigns, are bound to the obligee. Finally, the bond concludes with the "condition," upon fulfillment of which the obligation is to be deemed discharged, namely, performance by the principal.

936. Surety companies: nature of surety business. Surety companies—that is, corporations organized for the purpose of engaging in the business of becoming sureties upon bonds and undertakings—occupy a somewhat different status from that of gratuitous sureties. Strictly speaking, when a company is engaged in assuming risks for compensation, it is engaged in the business of insurance rather than in the making of special promises to answer for another's debt, default or miscarriage. Hence the rule of *strictissimi juris* (sec. 926) is not so readily enforced in the case of surety companies as in the case of gratuitous sureties. Thus, where a creditor or obligee, upon the principal's default, fails to give a gratuitous surety prompt notice of such default, and the suretyship contract provides for such notice, the surety would be discharged, whereas the failure to give such notice to a surety company, notwithstanding a provision for such notice in the bond, would not discharge the company unless the delay was unreasonable or resulted in some prejudice to the company. "Prompt" or "immediate" notice in such cases has been construed to mean reasonable notice. (See sec. 1701.)

Classification of surety bonds. Surety bonds are now commonly issued by surety companies instead of being given by gratuitous sureties as a matter of accommodation. Surety bonds may be classified as (1) business bonds, (2) official bonds and (3) judicial bonds.

937. Business bonds. Business bonds are given to secure business obligations. They include *fidelity bonds* and *contract bonds*.

Fidelity bonds: nature and purpose. Fidelity bonds guarantee the faithful performance of duties on the part of business officers, agents and employees in positions of trust, and protect employers against loss sustained through dishonest or criminal acts of employees. Fidelity bonds are frequently required by banks, financial institutions, fraternal and benevolent

societies, and organizations generally that entrust to employees the handling of substantial funds or property.

Fidelity bonds: conditions of liability. Although, as stated, surety companies are not entitled to the same degree of stringency of performance as in the case of gratuitous sureties, they may insist on a strict performance of the conditions in the bond. The duties of the employee may not be materially enlarged nor the fidelity risks materially varied without the surety company's consent. A surety company is entitled to full disclosure by the obligee in respect to all facts pertinent to the risk, especially where inquiry is made as to such facts. Upon discovering any dishonesty or material default on the part of the employee, the obligee or employer must notify the surety company with reasonable promptness in the light of all the circumstances (sec. 1701), and must likewise promptly discharge the employee. The writing of a fidelity bond being in the nature of insurance, the obligee must make full disclosure to the surety company of any facts within his knowledge bearing upon prior dishonesty or irregularity on the part of the prospective employee. If during the course of employment the employee is guilty of any act of dishonesty or infidelity that comes to the knowledge of the employer, a failure to notify the surety company of such default within a reasonable time may defeat recovery on the bond,¹⁷ especially where the bond requires prompt notification of such default and where a failure to give such notice has prejudiced the rights of the surety company. Where, however, failure to give prompt notice does not prejudice the rights of the surety company, the latter will not be discharged on its bond, unless a specific time limit for notice has been fixed in the bond and such notice has not been given. Some states fix a minimum time limit which a fidelity company may impose. However, where an employer continues an employee in his service after the latter has committed a default and the employer fails to notify the surety company of the default or where the employer notifies the surety company but does not discharge the employee and the employee is then guilty of a second default, the surety company will be discharged from liability as to the second offense, but not as to the first. (See sec. 1703, subd. (c).)

Contract bonds guarantee the faithful performance of a contract. They most frequently concern *construction* and *supply* contracts. In the former case, they are sometimes referred to as *completion bonds*. Contract bonds are now required in practically all government contracts—Federal, state, county and municipal—and are becoming of increasing importance in contracts between private individuals.

Example: The liability of a surety in connection with a private building contract is to make good to the obligee for a failure of the principal to complete or to complete within a given time or in accordance with the terms and specifications of the building contract, depending on the terms and conditions of the bond. The bond may provide for notice to the surety of the principal debtor's default as a condition for holding the surety liable, in which event notice must be given. Or the bond by its terms may

¹⁷ *Miners Sav. Bank of Pittston v. Royal Indemnity Co.*, 326 Pa. 428, 9 A. 2d 543.

render the surety liable forthwith upon default of the principal debtor or builder.

938. Official bonds. Many statutes require that a public officer, before he assumes his official duties, shall furnish a bond for the proper performance of his office. A "public officer," in this sense, means every person holding a government office or position and required to take an official oath. Not every public officer, of course, is required to furnish a bond, and no public officer may be required to furnish a bond unless a statute so provides.

Official v. business bonds: change of principal's duties. An important distinction between a business bond and an official bond is that, in the former case, if there is a change in duties by agreement between principal and obligee, without the obligor's consent, the obligor is discharged; whereas in the case of official bonds, the sureties are held to contemplate any possible change in the duties of the public officer by statutory amendment, so that, unless they have protected themselves against such contingency by express provision, they will not be discharged by such change in official duties.

939. Judicial bonds. Judicial bonds are those given in connection with a judicial proceeding. Among the more common judicial bonds are:

Bail bonds, given on behalf of a person subject to imprisonment by judicial process, and guaranteeing compliance with all orders of the court, such as appearance upon a given day to stand trial, and so on.

Fiduciary bonds (judicial), prescribed in proceedings wherein some judicial appointee has the care and custody of another's property. Examples of such appointees are guardians, administrators, executors and receivers.

Court undertakings. The liability of surety companies on a court undertaking depends upon the nature of the bond issued. An *attachment bond* is one wherein a surety company guarantees that if an attachment proves to be unwarranted, damages up to the amount stated may be recoverable by the owner of the property attached. An *injunction bond* is one wherein the surety or bonding company agrees to indemnify the person against whom the injunction was procured from damage sustained by him if the injunction should prove unfounded upon the final trial or hearing of the issues. An *appeal bond* is one wherein the bonding company guarantees a sum, usually to include a judgment with interest and costs, in case the judgment should be affirmed on appeal. An appeal bond usually operates as a stay to prevent the judgment creditor from proceeding against the judgment debtor until the appeal can be determined, and in consideration of such stay, the successful litigant or person stayed is indemnified if the appeal should prove unwarranted by an affirmance.

Questions and Problems for Review

1. Define guaranty or suretyship. Name and define the three parties concerned in it. *NY May 1931 (9)*

2. Distinguish between (a) a suretyship and a guaranty, (b) a guaranty and an indemnity. *NY Nov. 1934 (6)*

3. Concerning a guaranty, explain (a) nature and purpose, (b) manner of making, (c) how the position of a guarantor of negotiable paper differs from that of an indorser. *NY Apr. 1934 (14)*

4. (a) What is the difference between an ordinary contract and one of suretyship?

(b) What duty does the employer of a "bonded" cashier owe to the indemnity (or security) company during the term of the bond? *AI May 1919 (6)*

5. A firm of public accountants made an agreement with a corporation by its president for the examination of its books. After the examination had begun, the accountants refused to continue unless the president personally guaranteed that they would be paid. This he agreed to do. After the performance of the work they demanded payment of him personally, the corporation being insolvent. Is he liable? Explain. *NY Jan. 1917 (2)*

6. *W* was employed by *A. E. Inc.*, of which corporation *Q* was an officer. *A. E. Inc.* owed *W* \$9000 back salary. *W* demanded payment and *Q* told *W* that he would pay the money himself in a few days if the corporation did not do so. *Q* also wrote *W* a letter reading as follows: "I will personally see that it is taken care of in a few days, as this is my responsibility." *W* sued *Q* for the salary. Can he recover? Give reasons. *NY May 1928 (13)*

7. How may the guarantor or surety be discharged from liability? *NY June 1916 (2)*

8. Enumerate five defenses that may be taken advantage of by a surety. *NY Apr. 1933 (11)*

9. Danver was asked by Reid to become a cosurety with Taylor for an obligation owed by Reid to Pawling. Reid had prepared a written guaranty, in the body of which the names of Danver and Taylor as sureties appeared. Danver signed this guaranty upon the express condition that Reid would procure Taylor's signature before delivery to Pawling. Reid ignored this condition and gave the written guaranty to Pawling without Taylor's signature. Can Pawling collect from Danver upon Reid's default in the payment of his obligation to Pawling? *AI May 1933 (8)*

10. *A* guarantees the performance of a contract by *B*. The contract, however, was performed by *B & Company*, of which firm *B* is senior member. On a breach of contract, the creditor brought an

action against *A* on his guaranty. Is *A* liable? Explain. *NY June 1920 (15)*; *NY Jan. 1918 (14)*

11. A tenant obtains a lease for a part of a building and secures a surety to guarantee the faithful performance of his contract with the landlord. Subsequently and without knowledge of the surety, the tenant obtains the rest of the building at an additional rental. On breach of contract by the tenant, the landlord sues the surety on the guaranty covering the part of the building originally leased. Is the surety liable? Explain. *NY Jan. 1917 (14)*

12. Stern, by a written instrument, legally guaranteed the payment by Colt of all charges for goods purchased from the Emporia Company. Colt failed to pay certain proper charges and the Emporia Company sued Colt. During the trial, the case was settled and discontinued upon Colt's written agreement to pay a stated amount in specific instalments, with the proviso that the entire balance of the stated amount would become due upon default in the payment of any instalment. Thereafter Colt defaulted in his second instalment. Is Stern liable on his guaranty? *AI May 1934 (5)*

13. *A*, a creditor, holds collateral belonging to *B*, his debtor, to secure payment of a debt. In addition, *C* has guaranteed the payment of the debt by *B*. The latter defaults and *C* pays the debt. What becomes of the collateral? *NY June 1920 (11)*; *NY Jan. 1919 (14)*

14. What is the liability of a surety company under a bond given by it: First, a fidelity bond and second, a court undertaking? *NY Jan. 1921 (3)*

15. State the liability of a surety in connection with a private building contract. *NY Jan. 1920 (1)*

16. Collins, the bookkeeper and cashier for Watson, was bonded by a surety company. On January 14, 1932, Collins in the course of his employment stole \$500 and Watson discovered this theft one week later. Watson notified the surety company but retained Collins in his employ because of sympathy for Collins' family and in reliance upon Collins' promise not to repeat the offense. On January 30, 1932, Collins in the course of his employment stole \$750. On February 1, 1932, Watson discovered this theft, discharged Collins and notified the surety company. For which, if either, of these losses can Watson recover from the surety company? *AI May 1932 (8)*

CHAPTER X

Insurance

940. Scope of chapter. This chapter deals with the nature of insurance and the particular requisites of insurance contracts; a summary of the more important rules governing fire, life, marine and other forms of insurance; the law governing insurance agents, brokers and adjusters; and the conditions under which insurance benefits may be refused, payments avoided and policies forfeited.

A. The Insurance Contract

941. Nature of insurance contract. Insurance is indemnification against the risk of loss, by distributing the loss over a group. If each of a hundred persons owns a vessel, the loss of any single vessel might spell financial ruin for the owner. But if all agree to contribute a fund out of which to reimburse any one owner upon whom such loss might fall, the weight of the loss is distributed over the group and all are assured against total loss from the contingency named. It is this characteristic, chiefly, that distinguishes insurance from gambling.

Insurance v. wager. If you toss a coin and I offer to pay you a dollar if it falls heads, you to pay me a dollar if it falls tails, one or the other of us must lose. The loss of one is the gain of the other. The transaction is a pure wager. But if you in common with many others pay me a given sum on my agreement to assume the risk of loss which any of you may sustain from a given cause, the transaction is of benefit to all; you are all assured against the risk of loss, and I make a profit measured by the aggregate of your contributions minus the aggregate of losses that I pay out. "In a wagering contract, the parties contemplate gain through chance; in a contract of insurance the parties seek to avoid loss by reason of chance. The gambler courts fortune; the insured seeks to avoid misfortune. The contract of gambling tends to increase the inequality of fortune, while the contract of insurance tends to equalize fortune."¹

942. Contract essentials. Insurance contracts, like all contracts, must conform to the general rules in respect to contract

¹ Vance, *Insurance*, sec. 24.

essentials. These essentials, insofar as they apply particularly to contracts of insurance, are discussed in secs. 943 to 954. The formal characteristics of the insurance contract, including the applicability of the statute of frauds and the different types of insurance policies, are discussed in secs. 956 and 957.

943. Parties. The parties to a contract of insurance are the *insurer*, who assumes the risk, and the *insured* or *assured*, whose risk is assumed. Insurers are frequently referred to as *underwriters*. Generally, any person or group of persons, individual or corporate, may be an insurer, provided there is contractual capacity (sec. 136). The bulk of insurance business is now done by corporations. Some states require insurers to be incorporated, because corporations can be more effectively regulated than private individuals. An exception is generally made in the case of "American Lloyds," unincorporated associations engaged chiefly in writing marine, fire and similar risks. In some states, individuals may be insurers provided they are duly licensed and comply with the statutory requirements.

944. Classification of insurance companies. Insurance companies may be *stock*, *mutual* or *mixed*.

Stock companies are corporations that issue stock. The stockholders, as a class, are separate and distinct from the policyholders. They are entitled to any profits available for dividends.

Mutual companies issue no stock. The policyholders automatically become members of the company. Thus the members, collectively, are the insurers, and each member, individually, is the insured. Profits after necessary expenses, reserves, and so on, are distributed as dividends among the members.

Mixed companies are partly stock and partly mutual. Profits are distributed in part to the stockholders and in part to the policyholders.

945. Mutual assent. As in all contracts, the contract of insurance becomes effective when the minds of the parties meet. Usually, the offer takes the form of an application for insurance, signed by the insured, with information necessary to enable the insurer to pass on the request. The unconditional acceptance of the application completes the contract. Sometimes, however, the acceptance is conditional; for example, where it provides that the contract shall not be deemed effective until the premium is paid and the policy delivered (sec. 958). Statements in an accepted application bind the applicant.

946. Consideration. The consideration for the insurer's promise to indemnify is the payment or promise of payment, by the insured, of a *premium* or *assessment*.

Premium and assessment distinguished. A premium is a periodical sum of money agreed to be paid to the insurers as consideration for assuming the risk. An assessment is a sum of money, to be determined by the financial requirements of the insurer, that the insured is obligated to contribute as the need arises.

Premiums: medium of payment. Premiums are payable in cash, by check or by note of the policyholder, as may be agreed. However, an agent authorized to collect premiums has no implied authority to collect anything but cash.

Premiums sent by mail: risk of nondelivery. Ordinarily, when one elects to transmit something through the mails, he thereby designates the mails as *his* agent, and the risk of nondelivery or delayed delivery is on the sender. However, if the sender uses the mails at the request of the recipient or in response to the latter's offer, the post office is thereby designated as the recipient's agent, and delivery is complete upon deposit in the mails. Hence, if a premium is sent by mail, nondelivery or delayed delivery is at the risk of the insured, unless the company or its authorized agent requested or directed payment by mail or unless such payment was impliedly authorized by a long course of conduct acquiesced in by the company. (For an example, see sec. 1727. See also, sec. 118 and sec. 221, "Payment by mail".)

947. Subject matter. The subject matter of an insurance contract is the assumption of a risk and the indemnification against loss that may be suffered by one exposed to it. The law places no limitation upon the character of the risk assumed, except to require:

- (a) A risk to the person insured—*an insurable interest*.
- (b) Legality of the transaction.
- (c) That the loss must not be deliberate.
- (d) Existence of the subject matter involving the risk.
- (e) Compliance with statutory provisions in respect to licensing and similar requirements.

948. Insurable interest: what constitutes. Regardless of the nature of the insurance or the subject matter of the policy, the person to whom a policy of insurance is issued must have an insurable interest in the subject matter of the insurance or the transaction is a gamble and unenforceable. One has an insurable interest in the subject matter insured if he stands to gain by its preservation and to lose by its loss, damage or destruction.

Example: If, for a consideration, I promise to pay you a sum of money in case it rains tomorrow, and you have no financial interest at stake in tomorrow's weather, such a transaction is clearly a gamble. But if you have some interest at stake in tomorrow's weather, some risk of loss—as, for example, by reason of conducting some open air event which would mean loss to you in case of rain—you have an insurable interest in the weather, and an assumption of that risk by another would constitute a valid insurance transaction.

949. Insurable interest in life. If a person is so related by blood, marriage, or business to another as to justify a reasonable expectation of benefit or advantage from continuance of the latter's life and loss or detriment from its termination, he has an insurable interest in such life. Husband and wife have each an insurable interest in the other's life. A father has an insurable interest in the lives of his children, since they might some day support him. Partners have an insurable interest in one another's lives. An employer has an insurable interest in the life of his employee, and vice versa. A creditor has an insurable interest in his debtor's life, and a surety in the life of his principal. A person has an unlimited interest in his own life, which will support a policy taken by him in favor of himself or his estate or in favor of another person as beneficiary, even though the beneficiary has no insurable interest in such life.

Corporations: insurable interest in lives of officers, and so on. A corporation has an insurable interest in the life of its president, general manager, principal stockholder or other person or officer on whose efforts the success of the corporation's business depends.² In case such officer retires or is removed or otherwise severs his connection with the company, the right of the corporation to keep up the premiums and collect the insurance is upheld in some states but not in others. (See sec. 1712, subd. e.)

950. Insurable interest in property. A person has an insurable interest in property when he has such right interest or relation to it that he will be benefited by its preservation and continued existence and will suffer a direct pecuniary loss from its destruction or injury by reason of the peril insured against. Persons held to have an insurable interest in property include: the holder of any legal or equitable title, such as a trustee and the beneficiary of a trust; a tenant in common (sec. 1032) of real property, or a part owner of personal property; a partner; a stockholder; an ordinary tenant; a life tenant (sec. 1027);

² *U.S. v. Supplee-Biddle Hardware Co.*, 265 U.S. 189.

a remainderman or a reversioner (sec. 1029); the holder of a mortgage or any other kind of lien (sec. 1128); any bailee, such as a carrier, warehouseman or pledgee; and a purchaser of real property under a contract of sale, though title has not yet closed or passed.

Mortgagor and mortgagee. A mortgagor of property (i.e., the owner) has an insurable interest therein to the extent of its full value, since he remains the owner notwithstanding the mortgage. He loses his insurable interest when, after foreclosure proceedings, he loses his right to redeem, or "equity of redemption" (sec. 1157), except where he remains liable on the mortgage debt (sec. 1156). In case of loss, he may recover the full amount thereof, if he was insured up to that amount.

The mortgagee (i.e., the holder of the mortgage) has an insurable interest in the mortgaged property to the extent of the mortgage debt, but only so long as the debt remains unpaid. However, a mortgagee recovers nothing in case of loss unless there is an agreement to this effect between the mortgagor and the mortgagee, or a policy issued to or for the benefit of the mortgagee. In the absence of agreement, a mortgagee has no lien on the insurance proceeds. (See sec. 1724.)

951. Insurable interest: some distinctions between life and property. In respect to insurable interest, there are two important distinctions between life and property insurance:

(a) *Expectation of benefit v. legal right.* In the case of life insurance, a mere expectation of benefit is sufficient, without legal right. In the case of property insurance, there must be either a legal right or interest in the property itself, or else an expectation founded on a legal right.

Examples:

(1) A sister may be dependent on her brother for support, without legal right to such support, yet such expectation alone is enough to give the sister an insurable interest in her brother's life.

(2) See sec. 1714.

(3) The foster parent of a child orphaned by his mother and abandoned by his father may have a reasonable expectation of benefit from the foster child in subsequent years, sufficient, as an insurable interest, to support an insurance policy taken out by the foster parent on the life of the foster child.

(4) Plaintiff took out a policy of insurance on the hull and equipment of the steamer *Falcon*. Plaintiff's sole interest was that he owned 36 shares of stock in the corporation that owned the *Falcon*. There was a loss, and defendant refused payment to plaintiff on the ground that he had no insurable interest. Held: for plaintiff.³

(b) *Time when insurable interest must exist.* In the case of life insurance, the insurable interest must exist at the time the policy is issued, but

³ *Riggs v. C. M. Ins. Co.*, 125 N.Y. 7.

need not exist at the time of the death or loss.⁴ In the case of property (such as fire or marine) insurance, if there is no insurable interest in existence at the time of the loss, there can be no recovery.

Examples:

(1) To secure a debt, *X* gives *Y* a mortgage on *X*'s home. *Y* takes out a policy of insurance on *X*'s life, also a policy of fire insurance on *X*'s home. Later *X* pays the debt and the mortgage is canceled. *Y* keeps up the premiums on both policies. Still later, *X* dies in a fire that destroys his home. *Y* may recover on the life but not on the fire insurance policy.

(2) A creditor may recover on a life policy covering the debtor's life notwithstanding payment of the debt (sec. 1710).

(3) A policy on the life of a spouse is payable notwithstanding divorce.⁵

Beneficiary need not have insurable interest. Only the person who procures a policy of insurance need have an insurable interest in the life of an insured. A beneficiary may even be a stranger to the insured.

Example: *X* insured his life for the benefit of *Y*, a friend. He then, with *Y*'s consent, assigned the policy to *Z*, a stranger, for \$1000. Upon *X*'s death, the company refused payment to *Z* on the ground that neither *Y* nor *Z* had an insurable interest in the life of *X*. Held: for *Z*. A beneficiary need not have an insurable interest in the life of the insured.⁶

952. Legality of transaction. The business of insurance is valid so long as it does not represent a mere gambling transaction, as in the case of betting on a risk without insurable interest.

Crimes. It is lawful to insure a risk based on the crimes of *others*, but not on the crimes of the insured. For example, a person may be insured against the risk of loss through burglary but not against the risk of loss through his own crimes.

Torts. Insurance is payable regardless of the fact that the loss was occasioned by a tort, so long as the tort was not wilful or deliberate. For example, a life insurance policy is payable though the loss of life is due to the insured's negligence. Likewise, fire insurance is payable notwithstanding an employee's negligence.

953. Deliberate losses: suicide. Losses caused by the deliberate acts of the insured are not recoverable; for example, there can be no recovery for fire losses if the fire was caused by the insured's deliberate act. If a policy of life insurance were to stipulate for payment in the case of suicide, it would be contrary to public policy and void. However, if a policy is

⁴ Some policies, however, require that an insurable interest continue throughout the life of the policy. A few states have adopted statutes to such effect.

⁵ *Edgington v. Equitable Life Assur. Soc.*, (Iowa), 20 N.W. 2d 411.

⁶ *St. John's v. Insurance Co.*, 13 N.Y. 31; *Smith v. Coleman*, 184 Va. 259, 35 S.E. 2d 107.

silent on the subject of suicide, or even if it provides that the insurer is not to be liable in case of suicide, the law permits recovery under certain conditions (sec. 984).

954. Existence of subject matter. A contract of insurance is invalid where the subject matter is not in existence at the time the risk attaches and such fact is known to one of the parties. For example, if a ship is lost at sea and the owner, knowing it, insures the vessel with an insurer ignorant of the fact, the policy is void. But if both parties were ignorant of the loss, the policy would be valid. Marine risks are sometimes accepted on this basis. (See sec. 964.) If a policy of life insurance is taken out by a creditor on the life of a debtor, and the debtor, unknown to both parties, has in the meantime died, the insurance is valid notwithstanding.⁷

955. Licensing and other requirements. Every state regulates the conditions under which it will permit insurance to be conducted. Statutes generally declare insurance policies void if issued within the state unless the insurer has complied with statutory requirements. These include procurement of a license, payment of a license fee, and compliance with regulations in respect to capital, surplus, reserves, liabilities, investments, deposits, and so on. Supervision is exercised by a state superintendent of insurance who, through his representatives, makes periodic audits and inspections and requires periodic reports to insure compliance with the law.

956. Insurance contracts and the statute of frauds: policies. The law does not require ordinary contracts of insurance to be in writing. Even an oral contract of insurance for a term of years need not be in writing, because such a contract *may* be performed within a year by the happening of the event insured against; that is, the contract is not one that by its terms *must* take longer than a year to perform (sec. 183). In some jurisdictions, however, the statutes expressly require a contract of insurance to be in writing. Georgia is an example. In New York, the statute of frauds requires that every agreement, the performance of which is not to be completed before the end of a lifetime, must be in writing to be enforceable. This would seem to include contracts of life insurance. Other states prohibit the issuance of certain kinds of insurance unless a copy of the form of the policy has been filed with the insurance com-

⁷ *E. J. Riegel v. American Life Ins. Co.*, 140 Pa. 123, 21 A. 392.

mission. Since no copy of a form can be filed unless it is in writing, this amounts to a requirement that the contract of insurance be in writing.

A *policy* (from the Italian “polizia”) is the formal contract of insurance, embodying its full terms and conditions.

957. Form of insurance contract: standard provisions. Formerly, different policies issued by different companies throughout the country varied widely in coverage, risks included and excluded, technicalities (often in fine print) resulting in avoidance or forfeiture, and tricky clauses generally. Ultimately, the various state legislatures devised standard provisions that must be incorporated into policies before the insurer will be allowed to do business. Standard fire insurance clauses came first. Standard provisions are now generally applicable to numerous other forms of insurance. In New York, for example, there are compulsory standard clauses not only for ordinary fire and life policies, but also for most other forms of insurance written in the state. The standard fire insurance policy originally formulated by the New York Board of Fire Underwriters has been adopted in many other states. The tendency in all states is toward prescribing by statute certain clauses and provisions for all branches of insurance that must be embodied in the policy before a company will be permitted to do business in the state.

958. When contract effective. Ordinarily, life insurance companies stipulate that the contract is not effective until the policy is delivered and the premium paid. This is not the rule, however, with property insurance. In fire insurance, for example, if there has been a complete meeting of the minds on the terms of the risk, the insurer becomes liable even if a fire breaks out before the policy is delivered. This is usually evidenced by a brief written memorandum or commitment in the form of a “binder” (sec. 969).

959. Assignability of insurance contracts, generally. As already pointed out (sec. 209), a contract is not assignable if it creates a personal relationship or if its terms prohibit assignment. Some policies are construed as creating a personal relationship, others not. Many policies specifically prohibit a change of interest. This subject is more fully discussed in secs. 975 and 992.

960. Forms of insurance. As noted in sec. 1041, the law places no limitation upon the character of the risk assumed,

given the validity of its subject matter and the existence of an interest therein on the part of the person assured. Insurance first took the form of indemnity against *marine* losses. *Fire* insurance came much later, and *life* insurance still later. *Accident* and *health* insurance were naturally derived from life insurance. So extensively has insurance developed, that it now covers practically every form of risk known to business. (See secs. 994 to 1000.)

B. Marine Insurance

961. **Origin and nature of marine insurance.** Modern insurance, as we know it, originated in marine risks. Merchants gathered at Lloyd's seventeenth century coffee house, in London, with a vessel about to embark for a foreign port, would pass around a slip containing a designation of the vessel, its cargo, the name of the master, character of the crew, and voyage contemplated. Those present who desired to insure the venture, would "underwrite" it, that is, would write their names or initials underneath the data on the slip, with the amount for which each was willing to be liable in case of loss.

Marine insurance protects against hazards known as *perils of the sea*—fire, shipwreck or piracy. The term *perils of the sea* does not include the ordinary action of wind and wave, wear and tear, or loss due to delays occasioned thereby.

962. **Time v. voyage policies.** A *time* policy is one that fixes the duration of the risk in terms of a fixed period, such as from noon of May 1, 1948 to noon of May 1, 1949. A *voyage* policy is one in which the duration of the risk is measured by the limits of the voyage; for example, from New York to Bordeaux.

963. **Subject of insurance.** The subject of marine insurance is not only the vessel itself, but its cargo, tackle, and accessories. Unless specifically covered in the policy, however, insurance on a vessel's cargo does not include goods stowed on deck, livestock and their fodder, bullion, personal belongings of crew and passengers, and provisions or stores for use on the voyage.

964. **Seaworthiness: original defects.** A fundamental warranty in marine insurance is that the vessel is seaworthy. If this warranty is untrue, the insurer will not be liable.

Example: If a vessel founders from a leak, the underwriter is liable for the loss, or not, depending respectively on whether the loss is due to violence from without or weakness from within.

965. "Lost or not lost." Where a policy contains a provision for insurance of a vessel "lost or not lost," the underwriter assumes not only the risk of future loss, but also the risk of loss that may already have occurred. Of course, if the assured has knowledge of the loss at the time when the policy is issued, he cannot recover from an underwriter who assumed the risk without such knowledge. The stipulation for insurance on a "lost or not lost" basis covers situations where the location of the vessel is unknown and knowledge of possible loss is unavailable.

966. *General average v. particular average.* The amount of loss for which a marine insurer is liable is fixed in the policy. From earliest days, however, it has been the custom to resort to the "general average." Where goods are *jettisoned*—thrown overboard to lighten and save the ship—they are sacrificed for the benefit of cargo and ship as a whole, that is, such loss works to the benefit of the owners of the ship and the rest of the cargo not jettisoned. It is therefore customary to incorporate, into marine policies, a *general average* provision, whereby the underwriter undertakes to collect, from the owners of the vessel and of cargo saved by jettison of particular goods, a contribution to make good the loss on the particular goods, thus averaging up the loss. *Particular average* relates to the actual insurance paid by the underwriter on the particular thing insured.

Proofs of loss. Payment of loss will not be made without proofs of loss. These must give full particulars of the nature, amount and cause of damage, sworn to by the master and crew of the vessel. Bills of lading and similar documents must be submitted to prove title. An investigation is usually made by the government surveyor of the port or by experts chosen by both sides. If the parties cannot agree as to the amount of damage, the damaged goods are sold at auction and the amount is determined in that way.

C. Fire Insurance

967. *Standard fire policy.* In many states, a standard fire policy is prescribed by statute or by a commissioner of insurance with statutory authority. New York pioneered such a statute, and many other states have adopted the New York

standard fire policy merely by reference to such form. The purpose of such statutes is threefold: (1) To protect the insured against obscure or tricky language offering escape from liability in case of loss, (2) to secure uniformity in insurance contracts, and (3) to protect insurance companies against fraud and imposition on the part of the insured and the perils of alleged oral waivers by their local agents.⁸ Most of the legal principles referred to in secs. 968 to 976 are embodied in such standard clauses.

968. Definition and coverage. A fire insurance contract indemnifies the insured against property loss by fire. It covers not only direct loss due to fire, but also loss accompanying or resulting from a fire, such as damage by smoke, water or chemicals. However, a "friendly fire," as distinguished from a "hostile fire," is not covered by the ordinary policy of fire insurance.

Friendly v. hostile fire. A fire kindled or employed for ordinary purposes, as for lighting, heating or manufacturing, is said to be of *friendly* origin, and unless otherwise provided in the policy, loss or damage resulting from such a fire is not recoverable. A *hostile* fire is one that breaks out where not desired or intended or that is intended for a legitimate purpose but becomes uncontrollable.

Example: In *Mode v. Fireman's Fund Ins. Co.*,⁹ the Court held that a fire policy did not cover loss resulting from the fact that an article of value was accidentally thrown into an incinerator fire, which was of friendly origin.

969. Binders. As pointed out in sec. 958, a contract of fire insurance may take effect before the policy is delivered. Usually, the meeting of the minds is evidenced by a "binder" or "binding slip." This consists of a written memorandum giving temporary protection pending delivery of the policy. The binder sets forth the essential terms of the insurance contract, including location of property, amount of insurance, premium, and so on. It is subject to the conditions to be subsequently incorporated into the policy.

970. Valued v. open policy. A *valued* policy specifies the value of the property insured. An *open* or *unvalued* policy leaves the value open, to be determined at the time of the loss. Policies may be both valued and open: Valued, to the extent that the insurance company agrees to pay a specific amount

⁸ 44 *Corpus Juris Secundum* 1026, and cases therein cited.

⁹ 62 Idaho 270, 110 P. (2d) 840.

in case of total loss, and open, to the extent that it agrees to pay, in the event of a partial loss, an amount to be fixed at the time of loss. Fire insurance policies are usually of the latter type, or else entirely open. A valued policy does not imply that the amount payable is the amount that will be paid in case of loss, but rather that such amount will be paid in case of *total* loss.

Amount recoverable: fire v. life. In a fire insurance policy, only the actual loss sustained is recoverable; in a life insurance policy, the loss sustained is the principal sum specified in the policy. The purpose of stating a specific amount of insurance in a fire policy is to fix a maximum recoverable. See sec. 1720, subd. (a).

Option to restore or rebuild. Fire insurance companies are generally given the option to restore or rebuild destroyed property. The usual standard clause provides that it shall be optional with the company "to take all or any part of the articles at ascertained or appraised value, or to rebuild or replace property, lost or damaged, within a reasonable time, on giving notice within thirty days after receipt of proofs (of loss)." See sec. 1720, subd. (b).

971. Other types of fire policies: blanket, specific and floating. *Blanket* or *compound* policies insure for a gross sum and cover several kinds of property in one or more localities without apportionment among them. A *specific* policy covers a specific item of property in a specific amount or various items in specific amounts apportioned among them. *Floating policies* cover property of a transitory nature, and not necessarily the same identical property. For instance, a merchant may insure his stock with the understanding that it is to be replaced by other material of the same kind. In case of loss, he may recover on the stock on hand at the time of the loss, regardless of what was on hand at the time the policy was issued.

972. Co-insurance. The standard co-insurance clause is designed to induce owners to insure their property at a higher percentage of its value. The tendency is to insure property at less than its full value, because most fires result in partial loss. Thus, the owner of a \$10,000 house might normally be tempted to save insurance premiums by insuring the house for half or two-thirds of its value. A co-insurance clause provides that if the owner will insure his property up to a given percentage of its value (usually 80%), he will be given the benefit of a lower premium, and if he insures for less than the fixed percentage, he must himself bear a proportion of any loss,

that is, he must be a co-insurer on such loss. In the latter case, he may recover only such percentage of the loss as the actual amount of insurance bears to 80% of the value of the property.

Examples:

(1) A storekeeper has a stock of merchandise worth \$10,000, on which he has a fire insurance policy for \$6000 with an 80% co-insurance clause. Fire destroys \$4000 worth of his merchandise. The storekeeper will recover \$3000. (See sec. 1721, subd. c, for calculation.)

(2) See example in sec. 973.

973. Concurrent insurance: pro rata clause. Where property is insured in more than one company and the total concurrent insurance exceeds the general loss, the standard *pro rata clause* applies; that is, the insured can collect from each company only its proportionate or *pro rata* liability to the total amount of insurance. (See sec. 1725, subd. d.)

Example: The owner of a building worth \$50,000, believing his loss by fire will not exceed \$20,000, takes two standard policies with 80% co-insurance clauses, one in the A Company for \$12,000, and the other in the B Company for \$8000. He sustains a fire loss of \$20,000. Under the 80% co-insurance clause, he should have insured for 80% of value, or \$40,000. He actually insured for \$20,000, or half. He will therefore recover half the loss, or \$10,000. Under the *pro rata* clause, he will recover this sum as follows: Three-fifths from the A Company and two-fifths from the B Company.

974. Occupancy of premises. The standard fire policy provides that if a building described in the policy, whether intended for occupancy by the owner or the tenant, becomes vacant or unoccupied and remains so for ten days, the *entire policy*, unless otherwise provided by agreement *indorsed on the policy or added to it*, shall be void. In such cases, it does not matter that the fire occurred after occupancy was resumed. The policy is voided.

Example: The holder of a policy containing the standard vacancy clause left her New York home vacant for several months while she visited friends in Philadelphia. Two days after she returned, the house burned down. The Court held that the violation of the occupancy provision voided the policy. The insured's return before the fire was immaterial.¹⁰

A policyholder desiring to leave the premises unoccupied without violating the vacancy clause should beware of relying on the oral permission of an insurance agent, though he be the

¹⁰ *Couch v. Farmer's Fire Insurance Co.*, 64 App. Div. 367.

one who issued the policy. In such a case, the Court has held that the policyholder has no right to rely on such permission, since the occupancy clause provides that such permission must be indorsed on the policy by proper authority.¹¹

Recent decisions have inclined toward a more liberal interpretation of the vacancy clause, the courts holding that temporary absence of the occupants with an intention to return will not render the building "vacant" or "unoccupied."¹²

975. Assignability of policy: change of interest. As noted in secs. 209 and 959, a contract is not assignable if it involves a personal relationship or if its terms prohibit assignment. A fire insurance policy involves a personal relationship in that the insured's character, habits, experience and background may be material to the risk.¹³ Moreover, fire policies almost invariably provide that the entire policy shall be void upon assignment without the company's written consent indorsed on the policy.

Assignment after loss. Once a fire loss takes place, the policyholder has a specific claim or *chose in action* (sec. 1054) against the company, and this he may assign, subject, however, to any defense by the insurance company (sec. 206). The insured may not, however, assign any excess of insurance over the loss. To that extent, the policy remains a personal and nonassignable contract.

Change of interest: alienation clause. The "alienation clause" of the standard policy provides that the policy shall be void "if any change other than by the death of an insured take place in the interest, title, or possession of the subject of insurance (except change of occupants without increase of hazard), whether by legal process or judgment, or by voluntary act of the insured or otherwise." Even without the alienation clause, it is obvious that the seller, having parted with his insurable interest when he parted with title, would be unable to recover any loss under the policy (sec. 951), and that the buyer could acquire no right by assignment, to a personal contract between the seller and the insurance company; in short, that a fire insurance policy, unlike a fixed covenant in a deed, does not "run with the land." (See sec. 1717.)

Seller's choice as to unexpired insurance. A seller of premises covered by unexpired insurance has the choice (1) of obtaining a credit from the insurance company for the unearned premium, which usually means sacri-

¹¹ *Walsh v. Hartford Fire Insurance Company*, 73 N.Y. 5.

¹² *Foley v. Sonoma County Farmers' Mut. Fire Ins. Co.*, 18 Cal. 2d 232, 115 P. 2d 1, prior opinion, Cal. App., 108 P. 2d 939; *Republic Ins. Co. v. Watson*, (Tex. Civ. App.), 70 S.W. 2d 441, 443.

¹³ *National Union Fire Ins. Co., Pittsburgh, Pa., v. Epstein*, 48 Ariz. 345, 61 P. 2d 1010; *Neiman v. Hawkeye Securities Fire Ins. Co.*, 205 Iowa 119, 217 N.W. 258; *Baughman v. Camden Mfg. Co.*, 65 N.J. Eq. 546, 56 A. 376.

ficing a discount upon the basis of a shorter rate, or (2) arranging to obtain the insurance company's consent to an assignment of the policy to the buyer, in which case he will receive payment from the purchaser of the full value of the unexpired insurance. (See sec. 1723.)

Change of interest by operation of law. Except where the change of interest results from death, any change by operation of the law, without the insurer's consent, voids the policy.

Examples: (1) A sheriff's sale of property pursuant to a judgment, (2) a foreclosure sale of the insured premises, (3) transfer of property to a trustee or assignee in bankruptcy proceedings. (Bankruptcy alone, or transfer of possession to a receiver, will not void the policy.)

Although death of the insured will not void the policy, the executor or administrator, to avoid possible dispute in case of loss during the administration of the estate, should arrange with the company for a prompt transfer of all fire policies to the name of the estate.

Joint ownership: change of partnership interests. Where persons are jointly interested in the insured property, as in the case of joint owners, partners, cotrustees, and so on, a transfer from one to the other or others has no effect on the policy. "It is only where a stranger is to be brought into contractual relations with the insurance company that the consent of the latter is essential."¹⁴ Thus, the admission of a new partner voids the policy.

Example: The Home Insurance Co. issued a policy to Verdier on his stock of hardware. Verdier took in Brown, a new partner, and gave him a three-tenths interest in the firm property, which was subsequently damaged by fire. Held: that the transfer of interest to Brown voided the policy.¹⁵

However, the subsequent *withdrawal* of a partner from the insured firm does not, in most jurisdictions, void the policy, even where the withdrawing partner sells his interest to an outsider, because the outsider thereby gains no right to become a partner but merely to demand an accounting (sec. 664).¹⁶

Prudent partners, to avoid forfeiture of insurance policies on partnership property in case of partnership changes, insist upon the insertion of a provision in the policy, after the partnership name, of the phrase, "as now or hereafter may be constituted."

976. Cancellation of policy. Both insurer and insured have the right to cancel a fire policy at will. The standard cancellation clause usually reads: "This policy shall be cancelled at any time at the request of the insured; or by the company giving five days' notice of such cancellation." (See sec. 1725, subd. c.)

¹⁴ *Hoffman v. Aetna Ins. Co.*, 32 N.Y. 405.

¹⁵ *Germania Fire Ins. Co. v. Home Ins. Co.*, 144 N.Y. 195.

¹⁶ A contrary rule prevails in Texas. In California, the Court has held that such transfer voids the policy only as to the interest of the retiring partner.

~~977.~~ **Disputed clauses in fire policy.** As noted in sec. 196 (f), ambiguous words and clauses in a contract are construed against the party who drew the contract and selected the words. Hence, in case of dispute as to the meaning of a clause in a fire insurance policy, the doubt is generally resolved in favor of the insured and against the company, which drew up the policy. (Sec. 1720, subd. c.)

D. Life Insurance

978. Definition and purpose. Life insurance results from a contract whereby the insurer, for a named sum to be paid annually or at other intervals, stipulates to pay a larger sum at the insured's death. Thus, the purpose of a life insurance policy is to assume the risk of loss caused by the insured's death and to make compensation for such loss to a person designated by the insured, known as the *beneficiary*.

979. Types of life insurance. Among the more common types of life insurance are the following:

Ordinary life (straight). An ordinary life, or straight, policy calls for payment of premiums straight through life, and the payment of a fixed sum to the beneficiary on the insured's death.

Limited payment life. A limited payment life policy calls for a limited number of premium payments, the insured being fully protected not only during the period of payments but for the rest of his life thereafter.

Endowment. An endowment policy provides for payment of a fixed sum to the insured upon conclusion of a given period of premium payments. The sum is payable either to the insured himself or, if he dies before the period of premium payment expires, to his beneficiary.

Term policies provide for insurance for a fixed term of years. In consideration of a low premium, the policy does not provide for any accumulations or permit the holder to take out a paid-up policy at the end of the term. Term policies are usually taken where the insured has not decided upon a permanent form of insurance, but desires to be covered in the meantime.

Tontine policies are those in which each policyholder agrees, in common with the other policyholders under the same plan, that no dividend return, premium or surrender value shall be received for a term of years, called the "tontine period." The entire surplus from all sources is allowed to accumulate to the end of that period, and is then divided among all who have maintained their insurance in force.

980. Standard provisions. As previously noted (sec. 957), standard provisions that must be incorporated into life policies have now been generally adopted. For example, no policy of

life insurance may be delivered or issued for delivery in New York unless it contains provisions for the following: (a) a grace period; (b) incontestability after two years; (c) making the policy the entire contract between the parties, including the application (if a copy of it is indorsed on or attached to the policy); (d) adjustment of payment in accordance with the insured's true age, if his age was misstated; (e) divisibility of surplus; (f) nonforfeiture privileges and options, and a specification of the reserve basis to be adopted in determining nonforfeiture benefits; (g) loan privileges; and (h) the privilege of reinstatement under certain conditions and upon certain terms. Moreover, (i) with certain exceptions, no policy may contain a clause exempting the company from liability for death in specified cases.

981. Thirty-day grace period. State statutes throughout the country generally impose a thirty-day grace period for the payment of premiums beyond the actual due date. The standard provision in New York is typical: "A grace of thirty days from the day when it would otherwise be payable shall be granted for the payment of every premium after the first, during which time the insurance shall continue in force."

982. Risks which may and may not be excluded. Statutes generally prohibit life insurance companies from excluding certain risks. For example, in New York no life policy may contain a provision excluding liability for death for any cause or causes except military or naval service, suicide within two years from date policy is issued, and aviation.

983. Incontestability. The "incontestable clause" of a life insurance policy is a provision to the effect that after a policy has been in force for a given length of time (the most common period is two years), the policy cannot be contested by the insurance company for misstatements by the insured or for any other reasons except those specified in the policy, such as non-payment of premiums or breach of some other specified condition.

Fraud. Whether, notwithstanding an incontestable clause, an insurance company may urge the defense of fraud depends upon the time from which the policy becomes incontestable. If it becomes incontestable from the date of issue, fraud is a good defense; if after a given interval, fraud is not a good defense, since the company might have ascertained the fraud during the interval. (See sec. 1010.)

Other defenses. Other defenses which may be good notwithstanding in-

contestability are: (1) That the risk is not covered by the policy (sec. 981); (2) lack of insurable interest (sec. 948); (3) defenses arising after loss, such as failure to file proof of death within a required period, and (4) suicide.

Proof of death. Failure to file proof of death within the time prescribed in the policy may defeat recovery, notwithstanding incontestability. Proof of death is ordinarily made out on forms prescribed by the company. Where direct proof is lacking, circumstantial proof may be offered. Absence for a fixed period may raise a presumption of the fact of death but not of the date when it occurred.¹⁷

984. Suicide. We previously noted that a policy that affirmatively provides for payment in case of suicide is void for illegal subject matter. However, the question as to when suicide is a good defense is another matter.

No suicide clause in policy: sanity v. insanity. In the absence of a suicide clause in the policy, self-destruction by the insured *while insane* will not defeat recovery. Self-destruction *while sane* defeats recovery in most jurisdictions unless the policy is payable to beneficiaries other than the insured's family or personal representatives, and even then recovery is barred if it can be shown that the insured, at the time he took out the policy, intended to commit suicide and thereby defraud the company.¹⁸

Suicide clauses in policy. The effect of a suicide clause in a policy depends upon its language. The words "death by self-destruction," or "died by his own hand," in a suicide clause, are construed in most jurisdictions to mean intentional, not accidental, self-destruction *while sane*; that is, such language, in most states, does not bar recovery if the insured committed suicide while insane, unless the policy specifically says that it does.

Regardless of the language of a suicide clause, suicide will not bar recovery after a specified period of incontestability unless the incontestable clause (sec. 981) excludes death from suicide.

Statutory provisions. In a few states, the statute provides that regardless of suicide clauses in a policy, suicide shall not constitute a defense unless the insured contemplated suicide when he took out his policy.

985. Policy as constituting the entire contract. Every life policy must contain a clause that the policy constitutes the entire contract between the parties or, if a copy of the application is indorsed upon or attached to the policy when issued, a provision that the policy and application shall constitute the entire contract between the parties.

Example: A applies for a life insurance policy and makes certain false statements on the application blank. The company issues a policy but tries to avoid payment of subsequent loss on the ground of A's fraud. It

¹⁷ *Hogaboam v. Metropolitan Life Ins. Co.*, 248 Wis. 146, 21 N.W. 2d 268.

¹⁸ 45 *Corpus Juris Secundum* 923.

nowhere appears in the policy that *A* made the false statements, but the company can produce the original application blank to prove the fraud. *A*'s beneficiary can collect on the policy and the insurance company will be unable to adduce the evidence of the false statements in question, since the statements contained in the application were obviously not embodied in the policy.

986. Age of insured. Formerly, a misrepresentation of the insured as to his age would defeat recovery on the ground of fraud or, at least, breach of warranty. This rule has been modified by statute in many states, some allowing the company an offset for the amount of premiums that should have been paid had the age been correctly stated and others holding the company liable for the amount of insurance that the premium paid would have purchased at the true age.

987. Nonforfeiture privileges. In the early days of life insurance, if a policyholder defaulted in the payment of his premium, he forfeited all previous payments, though a substantial part of them went into the reserve for payment in case of death. Standard policies now generally contain a provision specifying the reserve basis used in determining nonforfeiture benefits. After a given number of premiums have been paid (usually the first three annual payments), a reserve is accumulated that, after deduction of operation expenses, furnishes the basis for various options that must be extended to the insured in lieu of forfeiture, viz.:

(a) *Cash surrender* in an amount equal to the reserve less handling expense.

(b) *Extended insurance*, usually in the form of additional term insurance (sec. 978) in the same amount as the original policy and for as long a term as the surrender value will buy.

(c) *Paid-up insurance* for an amount that the insured's reserve or surrender value will buy.

988. Loan value. The standard provision most commonly in use is to the effect that after three full years of premium payment, a policyholder may borrow up to the amount of the policy reserve, less proper charges and deductions, upon assignment or pledge of the policy as security. Loan values during each of the first twenty years are shown in a table set forth in the policy. When the insured obtains a loan, his policy remains in force, provided he keeps up the premium payments. Interest is charged against the loan, and, if the policyholder dies, the company pays the principal sum, minus the amount

of the loan, with an adjustment for interest prepaid or accrued.

989. Reinstatement. The statutory provision in New York, which is similar to other standard provisions, is to the effect that "the policy will be reinstated at any time within three years from the date of default, unless the cash surrender value has been exhausted by payment or unless the period of extended insurance has expired, upon the application of the insured and the production of evidence of insurability, including good health, satisfactory to the insurer and the payment of all overdue premiums and the payment or reinstatement of any other indebtedness to the insurer upon said policy with interest . . ."

990. Divisible surplus: dividend options. The insurer must annually ascertain and distribute any divisible surplus accruing on the policy. The divisible surplus is calculated after a proper allowance (a) for the mortality rate, and the required reserve against it, (b) the interest rate and (c) operating expenses. In paying dividends, insurance companies usually give the policyholder various options:

- (a) Payment in cash.
- (b) Dividends to be applied toward reduction of premium.
- (c) Amount of dividend to be left with the company at interest.
- (d) Dividend to be applied toward the purchase of additional insurance, thereby increasing the face value of the policy.

991. Notice of premium due. Under the standard policy, insurance companies must notify policyholders when a premium is about to become due. Such notice must be given in writing not less than fifteen nor more than forty-five days prior to due date, or the policy will remain in force for at least a year after default. The notice must also state the penalty for failure to pay the premium on due date or within the grace period.

992. Assignability. A policy of life insurance is a *chose in action*: A right to have a certain sum of money paid on death. It differs from a policy of property insurance in that the loss insured against is one that is certain to happen. A substantial part of the value of a life policy lies in the right of the owner to certain immediate and marketable benefits inherent in the policy. If the insured has named himself as beneficiary and has paid the premiums, all value that lies in the policy is his. If he has named another as beneficiary, with right of rev-

ocation, his right to assign the policy is unimpaired. If he has not reserved the right of revocation, he must get the beneficiary's consent if he wishes to assign the policy. If, having an insurable interest in the life of another, he has insured such life for his own benefit and has paid all the premiums, the policy is his own property and he may freely assign it. Practically all life policies, however, contain a clause to the effect that: "No assignment of this policy shall take effect until written notice thereof shall be given to the company."

993. **Termination of risk.** A life insurance policy may be terminated (a) by *expiration*, as in the case of a term policy; (b) by *lapse*, through default in premium payment; (c) by *payment of the loss*; or (d) by *forfeiture*. The subject of forfeiture, including policy cancellations, is discussed in secs. 1008-1016.

E. Miscellaneous Forms of Insurance

994. **Casualty insurance.** The term *casualty insurance* is broadly applied to all forms of insurance covering loss or damage resulting from accident or unanticipated contingency, except fire and the elements. Although frequently used to designate health and accident insurance, the term "is more properly applied to insurance against the effects of accident resulting in injuries to property."¹⁹

995. **Accident and health insurance.** Accident policies insure against the contingency of accidental injury or accidental death. Many policies combine accident and health insurance. Sick benefits are frequently paid by fraternal orders under an arrangement that amounts to health insurance. It is immaterial to recovery that the accident insured against was due to the insured's negligence, so long as it was not deliberate.

Total disability. The term *total disability*, unless otherwise defined in the policy, means permanent inability of the injured to earn a living at his usual and regular calling. Thus, if a prize fighter loses an arm, he has sustained total disability, though he may obtain other employment.

996. **Liability insurance.** Liability insurance furnishes indemnity against loss or damage sustained by persons other than the insured, for which the insured might become liable. Originally, it related only to an employer's liability for injuries or accidental death of employees during the course of their em-

¹⁹ 44 *Corpus Juris Secundum* 476.

ployment. (See sec. 608.) Liability insurance now covers many forms of liability that the insured may incur toward others, such as owner's liability to a tenant or others; a contractor's liability toward employees and others injured or killed during the course of some building or other construction; automobile liability to passengers, pedestrians and other car owners; the liability of a physician, dentist or hospital to a patient; and many others. The insurable interest in this type of risk is the loss that the insured may sustain by reason of his liability toward the person or persons who may suffer the damage or injury in question.

997. Burglary insurance. Burglary insurance protects property owners from loss by burglary. To exclude "inside jobs," burglary policies usually provide that payment shall be made only when loss results from unlawful, violent and external entry into buildings where the property is kept, of which violent and external entry there must be some visible mark or evidence, such as the breakage of a window or the forcing of a lock. A burglary insurance policy may prescribe the conditions and safeguards upon which liability is based. In the absence of such conditions and safeguards, the company will not be liable.

Example: An indemnity company insured a bank against felonious abstraction of money and securities from its safes and vaults, provided they were closed with a time lock; otherwise, only in case forcible entry was made by the use of tools, explosives, chemicals or electricity directly on the vaults. The policy also covered damage to furniture and fixtures in the course of such entry. The bank was feloniously entered by key and the vault by someone who knew the combination, there being no time lock. Ledgers and other articles were taken. On suit by the bank, the Court disallowed recovery. The circumstances of the entry were not those covered by the policy, nor could the books and other articles be classed as furniture and fixtures.²⁰

998. Automobile insurance. Automobile insurance protects against the hazards incident to the ownership and operation of an automobile. These include:

²⁰ *Rosenthal v. American Bonding Co.*, 207 N.Y., 162. See also, *Citizens' Nat. Bank of Hot Springs v. Union Indemnity Co.*, 158 Ark. 398, 250 S.W. 329; *Wakem & McLaughlin, Inc., v. Royal Indemnity Co.*, 241 Ill. App. 427; *Jackson Steam Laundry v. Aetna Casualty & Surety Co.*, 156 Miss. 649, 126 So. 478; *Schoenfeld v. Royal Indemnity Co.*, 76 Pa. Super. 299; *Northwestern Casualty & Surety Co. v. Barzune*, Tex. Civ. App., 42 S.W. 2d 100, error dismissed.

Fire and theft, covering losses from these causes.

Liability for personal injuries or death caused by the owner or his agent to pedestrians or passengers.

Property damage liability for loss occasioned to the property of others, as where a driver negligently runs into and damages the automobile of another.

Collision insurance, covering the insured against damage to his own car from collision with another car or with anything else.

999. Title insurance. Title insurance protects purchasers of real property from loss due to defective title and from the expense of law suits arising therefrom. In connection with such policies, title companies generally furnish title searches in advance of the title closing. Frequently, a title policy contains exceptions or specified conditions in respect to which the company will not be liable. If these exceptions and conditions cover matters that would render the title unmarketable, the policy is of doubtful value. (See sec. 1046.)

1000. Other forms of insurance. In addition to the forms of insurance already mentioned, there are various other forms in common daily use.

Fidelity insurance protects against losses from fraud or dishonesty of agents or employees. (See sec. 937.)

Credit insurance protects against loss in connection with credit risks.

Unemployment insurance. (See sec. 615, subd. (c).)

Boiler insurance protects against property loss from boiler explosions. (Fire policies do not as a rule cover such losses unless the explosion results from a fire.)

Plate glass insurance protects against loss from breakage or destruction of plate glass.

Rain and hail insurance protects from losses occasioned by rain or hail.

Rent insurance protects against rent losses.

Tornado and wind insurance protects against losses resulting from wind-storms.

1001. Reinsurance. Underwriters not infrequently "reinsure" their risks in whole or in part with other companies, so as to avoid a concentration of risk beyond the point of safety. If an entire railroad system, for example, insures with the A Company, the latter, to limit its liability on a single risk that may run into many millions of dollars, may reinsure this risk with a number of other companies, thereby spreading the risk in case of loss. Companies with relatively limited resources

may elect to reinsure an overly heavy burden of risks to avoid an excessive drain on their resources in case of loss.

1002. Subrogation. We have already noted the right of a surety, upon making good the debtor's obligation, to be subrogated to the creditor's claim against the debtor, including any lien, pledge or collateral held by the creditor to secure the debt (sec. 930). In a loose sense, a fire, marine or indemnity insurance company is similarly said to be subrogated to the rights of the insured to the extent ("pro tanto") that it has made good the loss to the insured.

Examples:

(1) A fire insurance company, upon paying to a home owner the fire loss caused by sparks from a locomotive, is subrogated to the home owner's claim against the railroad company for negligence in causing the loss.

(2) A carries collision insurance (sec. 993) with the *X* Indemnity Company, covering damage to his automobile. *B* negligently runs into *A*'s car, damaging it to the extent of \$200. The *X* Indemnity Company, upon paying *A*'s loss, is subrogated to *A*'s claim against *B* for \$200.

F. Agents, Brokers and Adjusters

1003. In general. The rules applicable to agents and brokers generally have already been considered (Chapter VI). Certain rules particularly applicable to insurance agents and brokers are worthy of note. These rules, for the most part, have been created by statute to fit the requirements of the insurance business and to protect the public against overly technical practices. To that extent, the rules of the common law in respect to agents have been modified and extended.

1004. Insurance agent *v.* insurance broker. An insurance *agent* is customarily employed by an insurance company to solicit risks and effect insurance on its behalf. An insurance *broker*, as pointed out in sec. 587, acts as a middleman between insurer and insured. Under employment by no special company, he solicits insurance from the public, and having secured an order, places it with a company selected either by the insured or by the broker acting as the insured's agent. An insurance agent, therefore, usually represents the company, whereas an insurance broker represents the insured.

It is not always easy to determine whether an "insurance man" is agent for the company or for the insured. The use of the word "agent" or "broker" is not necessarily the test.

Their acts, and not their names, determine.²¹ Neither is the matter determined by a provision in the policy that the person who writes the insurance shall be deemed the insurer's agent and not the company's. Statutes in some states and decisions in others hold that such provisions must yield to the actual facts of each case, which alone determine the question whether a person is agent for the company or for the insured.

1005. Dual agency of insurance broker. Under the common law, agents cannot serve in a dual capacity, that is, on behalf of principals with conflicting interests (sec. 562). The interests of insurer and insured may, and often do, conflict, yet an insurance broker frequently finds himself in a situation where, in connection with the same risk, he may be acting first for the company, then, later, for the insured, or vice versa. "It is possible for an insurance broker, although first employed by one party to the insurance contract, to become during the progress of the negotiations the agent of the other; and in that event he may acquire rights, have powers, and incur obligations respecting both insurer and insured. The same person may be both an insurance agent and an insurance broker, and at different times act in both capacities; he may be the agent for insured, although as to the procuring of the insurance he also represents the company. Whether in a particular case or particular matter one acts as agent for the company or for insured depends on the intention of the parties, which is to be determined from the facts and circumstances of the case."²²

In the field of fire insurance, brokers generally do business on a free-lance basis. When they place insurance for a customer, they are agents for the latter, not the company. But once they issue the policy, with due authority to do so, they bind the company as its agent, and payment of the premium to the broker is payment to the company.

Examples:

(1) Simpson orally applies to Alexander, a licensed fire insurance broker, for insurance on a building owned by Simpson. Alexander delivers the policy and collects the premium. In selecting the insurer for Simpson, Alexander was Simpson's agent. In delivering the policy and collecting the premium, Alexander was the company's agent.

²¹ *Tri-City Transp. Co. v. Bituminous Casualty Corporation*, 311 Ill. App. 610.

²² 44 *Corpus Juris Secundum* 802-803.

(2) Suppose that Alexander had insured Simpson's building with two companies, each policy being in half the amount of the total insurance desired and each policy providing that the same might be declared null and void, at the insurer's election, if there was any other insurance on the premises and such fact was not duly indorsed on the policy. Suppose further that such fact was not indorsed on either policy and that thereafter, a fire having totally destroyed the building, both companies successfully resisted payment. Since in selecting the insurers, Alexander was Simpson's agent, Simpson's only recourse would be against Alexander for incompetence.

1006. When broker deemed authorized to receive premium.

Any insurance company that delivers a policy to a broker who has requested it on behalf of some insured, is deemed to have authorized the broker to receive on its behalf payment of any premium due on such policy. This abolishes the old rule that when a policyholder paid a premium to his broker and the broker failed to remit to the company, the latter was not bound, on the theory that the broker was agent for the insured, not for the insurer. Even where the policy contains a restriction upon the broker's authority to collect premiums, such provision may be deemed to have been waived by subsequent conduct.

Example: A licensed broker procures a new policy from the company, delivers it to the assured and collects the premium. He notifies the company that he has collected the premium, then fails to remit to the company after being billed for the amount of the premium. Although the policy contained a provision that the broker was to be deemed the assured's agent, the facts spelled out a waiver of such provision.²³ The company is bound by the payment, must seek recourse against the broker and cannot collect again from the assured. (See sec. 1729.)

1007. General agencies. It is customary in the insurance business, particularly in the fire insurance business, for general agents to be authorized by various companies to solicit and accept insurance on their behalf and to issue policies subject to subsequent cancellation by the company. "A general agent of an insurance company is usually one who is authorized to accept risks, agree on and settle the terms of the insurance contracts, issue policies by filling out blank instruments which are

²³ *Globe & Rutgers F. I. Co. v. Lesher, Whitman & Co.*, 126 Misc. 874, 215 N.Y. Supp. 225; *Casper v. American Equitable Assur. Co. of New York*, 143 Misc. 916, 257 N.Y. Supp. 632. See also, *Continental Casualty Co. v. Monvoison*, La. App., 195 So. 785, 787; *Creech v. Massachusetts Bonding & Insurance Co.*, 160 Va. 567, 169 S.E. 545, 547; *Pagni v. New York Life Ins. Co.*, 173 Wash. 322, 23 P. 2d 6; *Halls v. Rhode Island Ins. Co.*, 193 Wis. 16, 213 N.W. 649.

furnished him for that purpose, and to renew policies already issued, as distinguished from a soliciting agent who merely procures applications, forwards them to some other officer by whom the policies are issued, collects the premiums, and delivers the policies. An agent may be a general agent as to his powers, although he represents the company only in a particular locality or within a limited territory, and in the latter aspect is called a 'local agent.' . . . In the absence of notice . . . of any limitations on such agent's authority, a general agent may bind the company by any acts, agreements, or representations that are within the ordinary scope and limits of the insurance business intrusted to him, although they are in violation of private instructions or restrictions on his authority." ²⁴

Restrictions on a general agent's authority are binding on the policyholder if they are brought to the policyholder's attention, as where they are contained in the policy itself. In such cases, notice to the general agent does not constitute notice to the company.

Example: A policy containing a double indemnity clause provides for modification only upon home office approval. The policyholder mails to the local agent his notice of election to eliminate the double indemnity provision. After the agent receives the notice but before the home office gets it, the policyholder dies. The double indemnity provision is still in effect.

G. Avoidance and Forfeiture

1008. Avoidance and forfeiture distinguished. *Avoidance* generally means resisting an obligation when it accrues, such as the obligation to pay premiums, the obligation to pay losses, and so on. *Forfeiture* means cancellation by the insurer. It usually relates to a declaration by the insurer that the policy is terminated because of some act, omission, or breach of condition by the insured.

1009. Grounds for avoidance and forfeiture. The courts hesitate to work a forfeiture against the insured wherever it is possible to avoid doing so without violating the rules of contract. Ordinarily, covenants will be construed strictly against the insurance company, which frames them, and liberally in favor of the insured (sec. 196, subd. (f)). However, an insurer may cancel a policy or, upon receiving proof of loss, may

²⁴ 44 *Corpus Juris Secundum* 822-823.

refuse payment, on the following grounds: (1) Fraud; (2) concealment; (3) breach of warranty, representation or condition.

1010. Fraud. Contracts of insurance are no exception to the rule rendering all contracts tainted with fraud voidable at the option of the defrauded party. Fraud is particularly important in contracts of insurance. The insured has peculiar knowledge of the facts affecting the risk. The insurer must assume the risk based upon the insured's representation as to such facts. The law therefore places upon the insured an obligation to exercise the highest degree of faith in procuring the insurance contract. Fraud will not, however, furnish ground for avoiding a life insurance policy unless the false statements complained of are embodied in, attached to or otherwise made part of the policy. (As to the relationship between incontestability and fraud, see sec. 983.)

1011. Concealment. "A concealment in the law of insurance is the designed and intentional withholding of any fact, material to the risk, which insured in honesty and good faith ought to communicate. As a general rule a failure by insured to disclose conditions affecting the risk, of which he is aware, makes the contract voidable at insurer's option. However, the modern practice of requiring applicant to answer questions prepared by insured²⁵ has relaxed this rule to some extent, since information not asked for is presumably deemed immaterial."²⁶

1012. Warranties and representations. Both warranties and representations are statements made by the insured in procuring a contract of insurance. The two, however, are distinguishable.

Warranties, under the common law, are statements usually embodied in the policy itself. Whether material or not, a warranty must be literally true, or the policy may be voided.

Representations are oral or written statements made at or before the execution of a contract and not necessarily made part of the policy. Representations, though untrue, will not void the policy unless they induced the risk and were material to it.

Example: A representation, by the applicant for a fire policy, that the only out-building on the premises is a red barn will not furnish ground for

²⁵ So in the original. Presumably the word intended is "insurer."

²⁶ 45 *Corpus Juris Secundum* 153.

avoidance if the barn happens to be green; the color is immaterial to the risk.

1013. Modern rule governing warranties and representations.

The modern rule governing warranties and representations is designed to counterbalance the advantage given to insurance companies because of the rule that a warranty must be literally true, regardless of its materiality. The New York statute, for example, provides: "No breach of warranty shall avoid an insurance contract or defeat recovery thereunder unless such breach materially increased the risk of loss, damage or injury within the coverage of the contract"; that is, unless the breach of warranty was material. This provision also furnishes a counterweight to the provision commonly contained in insurance policies that all statements made therein shall be presumed to be warranties, not representations.

1014. Affirmative *v.* promissory warranties. An *affirmative* warranty is one relating to a fact, past or present; for example, a warranty as to freedom from prior illnesses. A *promissory* warranty is one relating to a future act that the insurer undertakes to do or not to do; for example, a warranty as to maximum quantity of inflammable matter to be kept on the premises.

1015. Warranties in fire policies. Owing to the character of the risk, the insured under a fire policy is required to subscribe to certain warranties as part of the contract. Among the more common warranties are the following:

(a) That there will be no change in title or possession of the property insured.

(b) That no additional insurance will be placed on the property without the written consent of the insurer indorsed on the policy.

(c) That the premises will not be left vacant for longer than a certain period.

(d) That the insured will not do anything to increase the risk.

1016. Breach of condition. For the breach of any condition made part of the insurance contract, the insurer may avoid payment or cancel the policy. Subject to statutory restrictions, a party has a right to say under what conditions he agrees to assume a risk. If these conditions are violated, the obligation becomes ineffective. Among the conditions that may be embodied in a policy are those that give an insurer the

right of cancellation, either absolutely or upon certain contingencies. (See secs. 1725, subd. c and 1727.)

Waivers. An insurance company may waive the breach of any condition in a policy or of any warranty or fraudulent representation by the insured. However, such waivers must be pursuant to the policy itself and to the standard provision that the policy constitutes the entire contract between the parties (sec. 985). For this reason, waivers by insurance agents are not generally binding.

Nonforfeiture clause. The right of a life insurance company to forfeit a policy is subject to the nonforfeiture clause imposed by statute. (See sec. 987.)

Limitation of action clauses. Time limits for suit are commonly incorporated into life, health and accident policies, in the form of standard clauses. The New York statute, for example, provides that no action can be maintained to recover on a forfeited policy of life or total disability insurance unless it is instituted within two years from the date of default. This does not apply to actions to recover one's cash surrender value or the amount of any paid-up or extended insurance. A similar provision governs health and accident policies.

Questions and Problems for Review

1. Define insurable interest in property. *NY Jan. 1919 (4)*
2. What is the difference between fire insurance and life insurance in the following respects: (a) Insurable interest, (b) amount of recovery on policy in event of loss or death? *NY Nov. 1931 (11)*
3. When must the insurable interest exist in marine and fire insurance policies in order to enable the insured to recover in the event of a loss? *NY Jan. 1923 (14)*
4. *A* owes *B* \$10,000. *B* takes out a policy of \$10,000 insuring the life of *A*. Subsequently, *A* pays the loan in full but *B* continues the policy. Is it valid? *AI Nov. 1928 (7)*
5. A corporation operating tugboats fails to insure them against loss by fire. *A*, one of the stockholders, insured one of these boats in a company of standing. Subsequently, this particular boat burned. Is the claim of *A* collectible? Explain. *NY June 1916 (8)*
6. James Logan, a stockholder in the Ocean Steamship Company, fearing the loss of his investment through destruction of the vessel, which was not insured by the steamship company, took out a policy of insurance on the vessel to the amount of his investment and paid the premium thereon. The vessel was subsequently destroyed by fire, and when Logan presented his claim to the insurance company, the latter declined to pay it on the ground that Lo-

gan had no insurable interest. Can Logan recover? Give reasons. *NY June 1922 (11)*

7. A twelve-year-old boy whose mother had died and whose father had abandoned him, was being supported by a man who had known both of the boy's parents for several years but who was not related in any way to the boy. One year after this support began, the man procured insurance on the boy's life payable to the man as beneficiary. Two years thereafter the boy died. At all times, from the date of the application for the policy until the boy's death, the insurance company's general agent and its local agent or solicitor knew all of the facts and circumstances of the case. Is the policy valid? *AI Nov. 1932 (3)*

8. Explain general average in marine insurance. *NY June 1916 (5)*

9. A building is burned down, owing to the carelessness of the employees of the insured. The insurance company refused to pay the amount of the loss on the ground of such negligence. Can the insured recover? Give reasons. *NY Jan. 1916 (9)*

10. For ten years the whereabouts of an insured debtor was unknown and, as the payment of premiums became burdensome, the creditor took a paid-up policy for \$2500 in lieu of the \$6000 policy then in force. Both parties assumed that the debtor was still living. The fact was that the insured debtor had died eight years before the creditor had taken this paid-up policy for \$2500. Has the creditor any remedy? Explain. *NY Nov. 1926 (14)*

11. A policy of fire insurance issued to a partnership in its firm name makes no mention of changes in the personnel of the firm.

(a) Does the subsequent withdrawal of a partner affect the validity of the policy?

(b) Does the subsequent admission of a new partner affect the validity of the policy? *AI Nov. 1931 (7)*

12. What are the duties of the respective parties in making a fire insurance policy? *NY Jan. 1920 (4)*

13. Is a fire insurance company liable to the insured under its policy, if a fire occurs prior to the delivery of the policy? Give reasons. *NY Jan. 1920 (3)*

14. Define (a) an open policy of insurance, (b) a valued policy of insurance. *NY June 1919 (4)*

15. In the course of an audit, you find that your client has recently purchased improved real estate. He shows you an unexpired, fire insurance policy accurately describing the buildings but payable to the former owner and not assigned or transferred to your client. He says he is fully protected because the buildings are insured and the policy "runs with the property insured." Is his statement correct? *AI Nov. 1930 (1)*

16. Roe's policy contained the provision that it shall be void "if the buildings described . . . be or become vacant or unoccupied and remain so for ten days." Roe nailed up the back part of the house, left the keys with a neighbor and went away on a visit, remaining about two months. During Roe's absence, no one either occupied or went into his house. Two days after he returned to the house, it burned down completely. Can Roe recover from the insurance company? Give reasons. *NY Jan. 1923 (15)*

17. A policy of insurance contains a clause exempting the company from liability if the insured premises remain idle or vacant 20 days without the permission of the company indorsed in writing on the policy. A policyholder applies to the agent who issued the policy for such permission, and the agent gives permission orally, saying that the written consent of the company is not necessary. The insured building burns. The owner sues the company. In whose favor should judgment be rendered? Why? What is the duty of an executor in regard to policies covering property of the testator? *NY June 1932 (12)*

18. An insurance company sends to the insured a notice and bill for premiums due on a certain date. Nothing is said in the notice about the penalty if the premium is not paid on that day. The premium is offered to the company by the insured one month later but the insurance company refuses to accept it on the ground that the policy lapsed by failure to pay the premium when due. Is the company's contention right? Explain. *NY Jan. 1917 (7)*

19. The First National Bank of Bogtown effected a line of insurance with the Guaranteed Indemnity Company, covering insurance against the felonious abstraction of money and securities from its safes and vaults while the same were duly closed and locked. The insurance policy provided that if the safes or vaults were not locked by a time lock, the Indemnity Company would not be liable for the loss of money and securities abstracted therefrom, but only if forcible entry was made by the use of tools, explosives, chemicals or electricity directly on the vaults. The policy also provided that the Indemnity Company would be liable for all loss and damage to the office furniture and fixtures caused by the person, or persons, making, or attempting to make, such entry into the premises.

During the life of the policy, the bank was entered by someone having a key to the door, also to the book vault, which was not locked by a time lock but by a combination lock, the latter being opened by someone who knew the combination.

The bank sued the insurance company under its policy to recover for the loss of ledgers and other articles removed from the book vault, alleging that the loss of the books and articles constituted damage to the office furniture and fixtures. Will the bank succeed? *NY May 1925 (9)*

20. Henry Alexander was a licensed fire-insurance broker. Frank Simpson made an oral application to Alexander for insurance on

a building owned by Simpson. Thereafter Alexander delivered the policy and collected the premium. (a) For whom, if anyone, was Alexander an agent? (b) If he was an agent, when, if at all, did his principal change? *AI May 1931 (6)*

21. Anthony held a life-insurance policy to which was attached a supplemental contract providing double indemnity for death caused by external violent and accidental means, for which he paid an additional premium. By the terms of the policy, this supplemental contract could be discontinued "upon request of the insured and the presentation of the policy to the company for cancellation of this provision." The policy provided also that no person except certain officers at the company's home office was authorized to modify or waive any of the terms of the policy. On March 20, 1930, the company's local agent received from Anthony and mailed to the company's home office in another city the policy and Anthony's written request for the cancellation of the supplemental contract. On that evening, Anthony met with an external and violent accident which caused his death at 1 A.M. on March 21, 1930. The policy and request for cancellation were received by the company at 8:30 A.M. on March 21, 1930. Can the company be held for double indemnity? *AI May 1933 (10)*

22. Is an insurance company bound by the fraudulent act, or acts in disobedience of instructions, of an agent acting within the scope of his employment? *NY June 1921 (5)*

23. A applies for a life insurance policy and makes certain false statements on the application blank. The company issues a policy but tries to avoid payment of subsequent loss on the ground of A's fraud. It nowhere appears in the policy that A made the false statements, but the company can produce the original application blank to prove the fraud. Can A's beneficiary collect on the policy? Explain. *NY Jan. 1917 (6)*

CHAPTER XI

Property

1017. Scope of chapter. In this chapter we consider the nature and classification of property in general, and of real property in particular, including land and things connected with land, such as natural products of the soil, buildings, fixtures and chattels real; the various kinds of estates or interests in real property, and of easements; and the various ways in which real property may be acquired and disposed of, including title by occupancy, descent, marriage, devise and deed. We also consider the nature and kinds of personal property, including: personal property rights in relation to lands; tangible personal property, such as money, specie, currency, bullion, and ships; intangible personal property, such as accounts, annuities, patents, copyrights and trade-marks; and personal property in respect to income, with particular reference to interest and usury. Finally, we consider the acquisition and disposition of personal property, by appropriation, discovery, creation, gift, sale or exchange, will, and operation of the law.

A. Property in General: Nature and Classification

1018. Nature of property. Property is a legal relationship of persons to things, which gives persons control over things. It has been broadly defined as "any valuable right or interest protected by law." It is a "natural" or "absolute" right (sec. 18) guaranteed by the Constitution of the United States (sec. 21). A country may be rich in resources, but if it abolishes the right of ownership, property as a legal institution ceases to exist.

"Property" is sometimes used as synonymous with the word "title."¹

1019. Real *v.* personal property. All property is either real or personal. Real property is anything fixed, permanent and

¹ It is so used in the Uniform Sales Act.

immovable, such as land and things permanently annexed to land. All other property is personal. Although the distinction seems obvious, there are many borderline situations where the distinction is not always so clearly marked. (See secs. 1021-1025.)

1020. Tangible *v.* intangible real property. In the field of real property, tangibles embrace lands and things permanently annexed to lands. Such interests are sometimes said to be *corporeal*. Intangible rights in real property, also called *incorporeal* rights, are those not physically perceptible, but recognized to exist in law; such as an easement (sec. 1035).

(The subject of tangible and intangible personal property is discussed in secs. 1054-1075.)

B. Land and Things Connected with Land

1021. Land and its contents. All land, being permanent, constitutes real property. This includes not only surface, but contents; such as soil, clay, rock, minerals, and so on. But if such contents are removed from the land, their permanence is destroyed and they become personal property.

1022. Natural products. Natural products of the soil, while permanently annexed to it, constitute real property; severed, personal. If trees are sold standing, the transaction is a sale of real property; cut, personal. Crops while attached to the soil are real property; severed, personal.

1023. Water and ice. Flowing water cannot be deemed "annexed" to the soil. Hence it is not real property. Flowing water cannot be subjected to exclusive use by an adjoining owner, to the detriment of those above stream or below. However, an adjoining owner may make reasonable use of such waters. *Ice*, on the other hand, may be deemed definitely affixed to the soil of the owner, hence subject to his exclusive use.

1024. Buildings. Buildings remain real property so long as they are annexed to the land with intent of permanence. They cease to be real property upon being removed; as, for example, where a building is sold to a wrecking concern which is to remove it from the land. A building erected upon the land of another by the latter's license and consent is regarded as personalty belonging to the person who erected it and does not pass to a purchaser of the land unless he buys *without notice* of the facts as to separate ownership.

1025. Fixtures. Fixtures are chattels affixed to realty. They are *real* or *personal*, depending, respectively, upon whether they are affixed with or without the intent of permanence. Such intent may be expressed by the parties or implied from the character of the annexation. (See sec. 1731.) Where intent is not otherwise shown, the law raises one presumption where a thing is annexed by the owner for his own use and another where the annexation is by a tenant for his (sec. 1731).

Fixtures v. chattels real. Fixtures, as stated, are physical annexations to a building. *Chattels real* embrace less than freehold interests (sec. 1028) in lands, treated in law as personalty, or chattels; for example, a lease. (See sec. 1089.)

The subject of fixtures is further discussed and illustrated in section 1110.

C. Estates

1026. Estates defined and classified. The word "estate," broadly, means everything a person owns. As applied to real property, it means the interest one has in lands. Estates may be classified as follows:

- (a) *As to their duration:* freehold and less than freehold.
- (b) *As to present or future possession:* present and future estates.
- (c) *As to their absolute or qualified nature:* absolute and conditional estates.
- (d) *As to number and connection of owners:* joint estates, estates in common and estates by the severalty.
- (e) *As to courts of jurisdiction:* legal and equitable (trust) estates.

1027. Freehold estates: (fee and life estates). A freehold estate is a major interest in lands, of indefinite duration. The duration may be perpetual, running on indefinitely into the future, and automatically subject to inheritance if not otherwise disposed of by the owner (as by deed or will). Hence such an estate is called a *freehold estate of inheritance*, the most common form of which is an *estate in fee*. A freehold estate may also be one of *less than inheritance*, its duration being measured by someone's life. Hence it is known as a *life estate*.

Estate in fee. An estate in fee, or "fee simple," being of unlimited duration, is the largest estate or ownership in real property. It means ownership forever. It is the estate usually granted by deed, conveying title to the grantee "and his heirs forever."

Life estates may be created by *act of the parties*, as by deed or will; or

by *operation of law*, as in the case of *dower* and *curtesy* (sec. 1042). A life tenant may take from the land wood and timber necessary for fuel, current construction and repairs. This right is known as *estovers*; that is, the owner of a life estate ("life tenant") has the current use of the land. He is therefore responsible for its current maintenance, including taxes and carrying charges. A life tenant must not commit *waste*, which consists of impairment in the permanent value of premises, either by positive act ("active waste") or neglect ("passive waste").

1028. Less than freehold estates. Less than freehold estates include (a) estates for years, (b) estates at will, (c) periodic tenancies, (d) estates by sufferance and (e) statutory tenancies. (See secs. 1089-1094.) Such estates represent *personal property interests*, or chattels real (sec. 1025) in connection with lands, as distinguished from freehold estates, which are *real property interests*.

1029. Present and future estates. A present estate is one wherein the owner has present use or possession of the property. A future estate is one wherein possession is deferred. Thus, when the owner of a house and lot leases it to a tenant, the landlord has a future estate and the tenant a present estate. Future estates may be either in *reversion* or *remainder*.

Reversion. A reversion is the balance of a fee which goes back or "reverts" to a grantor after the lapse of a particular precedent estate granted by him.

Example: *X* owns an estate in fee, and grants to *A* a life estate. Nothing further being said, the estate in fee would revert to *X* upon the death of *A*, the owner of the life estate. If *X* is dead at the time of *A*'s death, the estate would revert to *X*'s heirs. The estate so reverting would be referred to as a *reversion*. It is a future estate because its enjoyment must await the expiration of the particular precedent estate.

Remainder. A remainder is the balance of a larger estate, which goes to some person other than the grantor, after a particular precedent estate expires.

Example: *X*, the owner of the fee, grants a life estate to *A*, and the remainder in fee to *B*. *A* has a present estate, namely, the right to present possession for his life; and *B* has the balance in fee in the future, after *A* dies. Such an estate is called a *remainder* rather than a reversion, because it does not revert or *go back* to the grantor, but is the balance or remainder which *goes on* to some person other than the grantor.

Particular estate. The estate which precedes a reversion or remainder is referred to as the *particular* estate. In both the above examples, the life estate to *A* is the particular or "precedent" estate.

1030. Absolute and conditional estates. If an estate is free from any conditions, it is called an *absolute* or *unconditional*

estate. Estates subject to conditions or restrictions are *conditional* or *qualified* estates.

Covenants running with the land are conditions limiting an estate. They bind not only the original grantee who took subject to such conditions, but also all other subsequent grantees or lessees. Such covenants cannot be "shaken off the land" by deed, will, assignment or transfer, because they are part and parcel of the estate to which they attach.

1031. Joint estates. If two or more persons acquire the same estate at one and the same time, by one and the same title or source of ownership, each having the same degree of interest as the others, and each having the same right of possession as the others, it is called a joint estate. In such a case, if one of the owners ("joint tenants") dies, his interest automatically passes to the others by *survivorship*, which is the characteristic feature of joint estates.

Tenancy by the entirety. If husband and wife are joint tenants, the estate is known as a tenancy by the entirety.

1032. Estates in common. An estate or tenancy in common is one held by two or more persons, each having an undivided interest which is not subject to survivorship. Thus, each "tenant in common" may sell his interest, or dispose of it by will, to an outside party. If he dies without having disposed of his interest by deed or will, his heirs and not the other "tenants in common" acquire his undivided interest. Under the common law, and prior to the adoption of statutes modeled on the Uniform Partnership Act, real property owned by a partnership was generally held by the partners as tenants in common. See section 1734, subd. (f).

1033. Estates by the severalty. When a person owns an interest in property by himself, such interest is known as an estate (or tenancy) by the severalty. Most property is thus held.

1034. Legal and equitable (trust) estates. The usual estate one has in property is known as a *legal estate* or *estate at law*. Normally, an owner's interest in property is recognized in an ordinary common law court. However, when one person holds title in real property *for the benefit of another*, the latter's interest is recognized only in a court of equity. Such an estate is therefore referred to as an *equitable*, or *trust* estate. Trust estates are more fully considered in Chapter XV.

D. Easements

1035. Easement; distinguished from license. An easement is a right which one has in the lands of another, either for his own convenience, or for the benefit of his own land. An easement is to be distinguished from a *license* in that the former is a definite interest in lands, whereas the latter is a mere permission or privilege not attaching to the land itself. Since an easement is an interest in lands, it must be created by a writing (sec. 184), whereas a license may be granted by oral permission.

Examples of easements:

- (1) Rights of way;
- (2) the right to use water (in streams, springs, wells, cisterns, and so on);
- (3) rights in highways, party walls, light and air.

Examples of licenses:

- (1) Permission to a fruit vender to put up his stand and sell his wares on the property of another;
- (2) the implied license of a contractor engaged to erect a house, or of a laborer to work on the premises, to enter upon the lands in question for such purposes.

1036. Easements classified. Easements may be either *in gross* or *appurtenant*. They may also be *public* and *private*.

Easements in gross. An easement in gross is one which exists for a person's own convenience and not in conjunction with any lands owed by him. The right of a person to use a public thoroughfare is an easement in gross.

Appurtenant easements: servient and dominant estates. An appurtenant easement is one which a person enjoys in conjunction with his own land. The land to which the easement is subject, and which therefore *serves* the land of the person who has the easement, is known as the *servient* estate. The land which is thus served by the easement is known as the *dominant* estate.

Examples:

(1) Mann sells part of his lands to Nagle, giving Nagle a right of way across his remaining property. Nagle has an *appurtenant* easement. The *dominant* estate is in Nagle, the *servient* estate in Mann.

(2) Lord owns a forty-story building adjoining a six-story building owned by Cushing. Lord acquires from Cushing an easement in light and air over Cushing's building for the benefit of Lord's building. Lord has an *appurtenant* easement. The *dominant* estate is in Lord, the *servient* estate in Cushing.

Public easements. Public easements are those enjoyed by the public at large, such as streets and public highways generally. The public has an easement of navigation and fishing in all tidal waters, such as oceans,

arms of the sea and navigable rivers with a tide; the adjoining owners own up to the ordinary high water mark. Shore rights are known as *riparian rights*.

Private easements. Private easements are those enjoyed by individuals as such, either *in gross*, or as *appurtenant* to lands.

1037. Creation of easements. Easements may arise by (a) grant or reservation, (b) natural right, (c) necessity, or (d) prescription.

Example of easement by grant: A gives or sells B, by deed or other instrument, a right to cross A's land.

Example of easement by reservation: A conveys a part of his land to B, and reserves the right to cross the part conveyed in order to get to the highway.

Example of easement by natural right: A and B are adjoining owners. Each has an easement by natural right to have his own land supported by the land of the other; for instance, to prevent undermining thereof by unreasonable excavation without taking precaution to shore up the adjoining land, to build a retaining wall, or otherwise to protect the adjoining property against collapse.

Example of easement by necessity: The owner of land along a highway conveys an inside parcel with no access to the highway. The law in such case creates an easement by necessity, giving the grantee a right to cross the grantor's land in order to get to the highway.

Examples of easement by prescription: (1) For fifteen consecutive years (the period varies in the different states (see sec. 1041)), members of the public indiscriminately cross A's lot, openly, "adversely" (without his permission), and notoriously. At the end of the period there arises a public right of way by prescription across A's lot.

(2) If B alone similarly crossed A's lot, and for the same period, a private easement would arise in favor of B alone.

1038. Extinguishment of easements. An easement may be lost or extinguished in the following ways: (a) by release; (b) by abandonment of the easement; (c) by adverse obstruction of the easement, as where the servient owner obstructs the easement openly and adversely, canceling it in the same way that it may be created, that is, by adverse use; (d) by union of the dominant and servient estates, as where the owner of the dominant parcel acquires the other parcel, or vice versa, and becomes the owner of both parcels.

E. Acquisition and Disposition of Real Property

1039. Title. Title means ownership. In real property title is frequently not absolute but qualified by flaws or defects.

The law distinguishes between a *perfect* and a *marketable* title.

Perfect v. marketable title. A *perfect* title theoretically embraces three elements: (1) right of property, (2) right of possession, and (3) possession. A person may have the right of property (ownership), yet lack a perfect title, as where he leases the property to a tenant and thereby parts with possession and the right of possession. He may have the right of property and the right of possession, but not possession, because a third party without right (say a "squatter") is in possession and must be ousted before the owner can convey a perfect title. Or the owner may have possession but not the right of possession, as where he has leased the premises but retains possession: His title is not perfect to the extent of the outstanding lease.

A *marketable* title, on the other hand, is one free from encumbrances, encroachments, restrictions, doubt as to validity, and so on. The owner may lack possession, or right of possession, or both, yet the title may be marketable. Thus, if the owner sells a fully rented apartment house which is drawing substantial revenue and which the buyer acquires for purposes of investment, the seller's title may not be theoretically "perfect," because the seller has voluntarily parted with possession and right of possession as to the apartments leased; but from the standpoint of marketability, the title may be excellent.

A vendor, though in wrongful possession, may convey good title if the purchaser is unaware that the vendor's possession is wrongful.

Example: On May 1, Jones advertises his house for sale or lease. On May 2, he leases the house to Smith, who is to move in on June 1. On May 15 Jones sells the house to Brown, who promptly takes possession. Brown's title is good if he had no actual or constructive knowledge of Smith's lease. Had Smith recorded his lease (sec. 1051), Brown would have had "constructive" knowledge of it.

1040. How title may be acquired. When someone disposes of title to real property, someone else necessarily acquires it. In considering the different ways in which title to real property may be acquired, we necessarily consider also the different ways in which it may be transferred. Title to real property may be acquired by (a) occupancy, (b) descent (inheritance), (c) marriage, (d) devise (will) and (e) deed. Descent and devise are discussed in Chapter XIV, "Wills, Inheritance and Estate Administration."

1041. Title by occupancy. The earliest form of acquiring title to real property was by occupancy ("First come, first served"). Title by occupancy also embraces titles acquired by discovery, by conquest, and by accretion (deposit of silt by streams, or of shore front by the tides). The most common forms of title by occupancy, however, are prescription in rela-

tion to easements (sec. 1037) and adverse possession in relation to title.

Adverse possession is the occupation of lands in such a way and for such a period that the real owner is barred from recovering title and possession. Where a person "openly, adversely [that is, without the owner's permission] and notoriously" occupies the lands of another for a *consecutive* period of years,² such person in wrongful possession, if left undisturbed by the true owner, acquires, at the end of the specified period, a title which is recognized in law, and which the true owner becomes powerless to dispute. In such case the adverse user, though his possession was wrongful up to the end of the prescribed period, may convey good title to another at the end of the prescribed period. To constitute adverse possession, the following elements must be found: (1) The possession must be under some claim of right; (2) it must be hostile to the owner; (3) it must be actual; (4) it must be open, visible and notorious; (5) it must be continuous; and (6) it must be exclusive.

1042. Title by marriage. Under the common law, the interest of a wife or husband in the other's property was known, respectively, as *dower* and *curtesy*. Both interests took the form of life estates (sec. 1027). Dower was a life estate in *one third* of the husband's real property; curtesy, a life interest in *all* the wife's real property. To counterbalance this disproportion, the widow's right of dower could not be defeated save by her own act (as by "signing away" the right, or by adultery), whereas the wife could always cut off the right of curtesy, either by deed or by will, so that the only way a husband's right of curtesy took effect was by the wife's prior death without will, and even then there must have been birth of issue, or curtesy would not take effect. The tendency in recent years has been to abolish the rights of dower and curtesy and to substitute, in their place, fee instead of life interests. In New York, for example, a widow or widower has the option of taking, in lieu of dower or curtesy, respectively, an out-and-out share, by way of inheritance, in the fee of the deceased spouse.

1043. Title by deed. A deed is an instrument by which title to real property is conveyed from one person to another. A deed is not to be confused with a contract of sale. The latter is an agreement to convey title; the deed is the conveyance itself. Frequently, the steps leading to the transfer of title by deed involve (a) an informal contract, or binder; (b) a formal

²The period varies. A common period is twenty years. The period in New York has been shortened from twenty to fifteen years. In some states the period is even shorter.

contract; (c) a title search in the interval between the making of the contract and the delivery of the deed; and (d) closing the title by the delivery of the deed on the one hand and payment of the price on the other.

1044. Informal contract or binder. When the buyer or seller of real property desires to bind the other party to the bargain, it is customary to write out an informal contract of sale, or binder, to serve until a more formal contract can be drawn up and signed by the parties. What such a memorandum must contain to be enforceable under the statute of frauds has already been noted (sec. 190).

1045. Formal contract of sale. An informal contract of sale may invite litigation by leaving open possible points of dispute. These should be covered in a formal and complete instrument properly drawn, which should specify: (a) date of contract; (b) parties; (c) exact description of property; (d) amount to be paid down at time of contract; (e) amount payable on delivery of deed; (f) amount of first mortgage subject to which title is taken, and whether or not such mortgage is assumed by the purchaser (see sec. 1151); (g) amount of purchase money mortgage, if any; (h) whether or not premises are taken subject to tenancies in possession; (i) covenants, conditions and restrictions subject to which purchaser is taking title; (j) who shall bear the risk of fire loss, pending closing of title; (k) when and where title is to be closed and deed delivered; and (l) what kind of deed is to be delivered (warranty deed, bargain and sale deed, quit claim deed, and so on; see sec. 1049).

Option v. contract. When a prospective purchaser does not wish to be bound by a contract of sale, he may take an option on the property in the form of an option agreement.

1046. Searching title. Between the date of the contract of sale and the date of closing title, it is customary to make a careful search of the public records to guard against prior conveyances, mortgage liens, mechanics' liens, tax liens, judgments and other incumbrances (Chapter XIII) not provided for in the contract.

Abstracts of title. In communities where title insurance policies are not available, it is customary to procure an abstract of title setting forth a condensed history of the title to the property which is being acquired, so that the purchaser may be assured that his title is good. An abstract of title

is taken from the public records affecting the parcel which is being sold, covering prior conveyances and decedent estate transfers showing the chain of title to the grantor, mortgages, mechanics' liens, judgments, taxes and other liens and encumbrances against the property, and similar information bearing on the state of the vendor's title.

Title insurance. The function of title insurance has been noted in section 999. When the purchaser orders a policy of title insurance, the title insurance company conducts a title search and reports on it to the purchaser or his attorney in advance of the closing. If flaws appear in the title, the purchaser or his attorney usually gives the seller a reasonable time in which to remedy them. If the flaws are not remedied and the purchaser takes title notwithstanding, the title company will except these defects from its policy of insurance; that is, the purchaser will not be insured against loss from such excepted causes, since the title company makes good only such loss to the policyholder as he sustains from the defects insured against.

1047. Closing title. Title is closed by the purchaser making payment and executing such instruments as are required in the contract of sale, and by the seller delivering to the purchaser a valid deed duly executed. If the purchase price is part cash and part mortgage, the buyer may have to execute and deliver a bond and mortgage (sec. 1145) as part payment of the price.

Purchase-money mortgage; junior and senior mortgages. A mortgage given to secure the unpaid portion of the purchase price is known as a *purchase money mortgage*. If added to an existing mortgage, it is known as a *junior mortgage*, such as a second or third mortgage, as distinguished from a prior mortgage, which would be a *senior mortgage*.

Example: Adams sells Baker a house and lot for \$20,000, payable as follows: \$5000 in cash, of which \$1000 is to be paid on the signing of the contract and \$4000 on delivery of the deed; \$10,000 by the buyer's taking the property subject to an existing first mortgage on the premises; and \$5000 by the buyer's executing and delivering to the seller his bond and mortgage in that amount. The latter mortgage is the purchase money mortgage, which is a junior lien on the premises, the \$10,000 mortgage being a senior lien.

Tender; adjournments. Each party, on the closing of title, must be prepared to make due tender in case the other defaults (sec. 222). Either party is ordinarily entitled to a reasonable first adjournment of the closing, unless the contract makes time of the essence (sec. 215).

1048. Remedies for default. When either seller or buyer defaults on the closing, the other party may sue at common law for breach of contract, or in equity for specific performance (sec. 242), or in a single suit for both. Contracts of sale frequently contain a clause (inserted at the seller's request) that if the seller is for any reason (other than his own deliberate default) unable to deliver a good title, the buyer's remedy shall

be limited to rescission of the contract and recovery of the amount paid in, plus expenses incurred in the examination of title. Also, if the contract so provides, the buyer has a lien on the property for the amount paid in.

Buyer's remedy when property is resold to another. When one contracts to sell property to a purchaser and before closing resells it to X at a higher price, the purchaser is presented with a choice of alternative remedies:

(1) He may merely rescind and recover from the seller the amount paid in plus expenses for examination.

(2) He may sue the seller for breach of contract, the damages being measured by the difference between the contract price and the market price, plus the amount paid in.

(3) If X had notice of the prior sale, the purchaser may join X and the seller in a suit for specific performance.

Remedy when property is sold on the installment plan. Ordinarily, when real property is sold on the installment plan and the purchaser fails to pay an installment when due, suit may be maintained for the amount of the past due installment or installments, but not for future installments.³ When, however, time is of the essence of the contract and default is made in the payment of an installment, the vendor may either rescind the contract, or he may affirm it and sue to compel specific performance. In addition, the vendor may sue for damages because of the breach. When an installment contract contains an "acceleration clause," that is, a clause which provides that if default be made in the payment of any installment, the full amount of the balance of the installments shall become due forthwith—the vendor may, upon default in the payment of any installment, sue forthwith for the balance of the purchase price.

1049. Kinds of deeds. There are numerous types of deeds. The most common are:

Full covenant and warranty deed, wherein the grantor warrants (1) that he owns the property and has a right to convey it, (2) that the purchaser's title will be protected against attack, (3) that the premises are free from incumbrances except those specified, (4) that the grantor will execute and procure any further documents or assurances necessary to perfect the title, and (5) that the grantor will forever continue to warrant the title.

Bargain and sale deed, wherein the seller conveys title without the warranties set forth in a full covenant and warranty deed.

Quit claim deed, wherein the seller does not purport to convey title, but merely to release any claim that he has to the property in question.

1050. Execution of deed. A deed is properly executed when it is (a) signed by the grantor, (b) witnessed or acknowledged, and (c) duly delivered.

³ 66 *Corpus Juris* 1407.

Signature. Formerly the grantor's signature had to be under seal. This is no longer the general rule in most states.

Acknowledgment. To acknowledge an instrument is to declare before a notary public, commissioner of deeds, or similar official that one has executed a certain document. The certificate of such official that such declaration has been duly made is known as the *certificate of acknowledgment*, or acknowledgment.

Witnessing. When an instrument is signed but no notary is available, a witness may acknowledge before a notary or commissioner of deeds that he saw the grantor sign. This is what is meant by "witnessing" a deed.

Delivery. Without delivery, a deed is ineffective as a conveyance. A deed takes effect from the date of its delivery, not from the date of recording.⁴ In the absence of proof to the contrary, the presumption is that a deed was delivered on its date.⁵ However, this presumption is subject to rebuttal. It may be shown that the deed was conditionally delivered, so as not to take effect until some subsequent date; or that the deed was delivered on a date subsequent to that indicated in the deed.

Delivery in escrow. Delivery in escrow means delivery to a third person instructed to deliver the instrument to the grantee upon compliance with certain conditions, such as payment of purchase price, and so on.

1051. Recording. A careful purchaser records a deed immediately upon its delivery so as to "give notice to the world" of his interest. All persons who thereafter acquire any interest or claim in the property do so subject to such notice.

Example: If Smith sells me a house and lot by a deed which I do not record, and then sells the same property to you by a deed which you promptly record, the law—as between you and me—gives you a prior right to the house, and my only recourse is to sue Smith. But had I promptly recorded my deed, such recording would have constituted notice to the world, including yourself, of my interest in the property, and your only recourse, under the circumstances, would have been against Smith.

F. Personal Property: Nature and Classification

1052. Nature and major classifications; "chattels." As noted in section 1017, personal property is all property not fixed or immovable. Articles of personal property are commonly termed *chattels*. Personal property may be broadly classified as follows:

- (a) *As to lands:* related or unrelated to lands.
- (b) *As to tangibility:* choses in possession and choses in action.

⁴ *In re Cray's Estate*, 353 Pa. 25, 44 A. 2d 286.

⁵ *Purdy v. Coar*, 109 N.Y. 448; *People v. Snyder*, 41 N.Y. 397; *Louisville, N. A. R. Co. v. Sumner*, 106 Ind. 55, 5 N.E. 404; *Carnahan v. Gupton* (Mont.), 96 P. 2d 513.

(c) *As to income*: productive and nonproductive.

(d) *As to origin of title*: by appropriation, discovery, creation, accession, gift, sale or exchange, will, and operation of law.

1053. Personal property in relation to lands. We have already noted such things connected with lands as trees, crops, water and ice (secs. 1022 and 1023). When fixtures constitute real property, and when personal, has been discussed in part in section 1025, and is further discussed in section 1110. Fish and game do not constitute property unless killed, or caught and kept. This applies even when one owns the land through which fishing streams flow or animals run wild.

Chattels real: leases. The distinction between chattels real and fixtures has been noted in section 1025. Chattels real embrace all interests in real property less than freehold (sec. 1028). Such interests, though connected with lands, constitute personal property. Hence, although a life estate is real property, a ninety-nine-year lease, though it may be more valuable than a life estate, is personal property. Leasehold estates are discussed in the next chapter.

Emblements. The right of a tenant to harvest crops planted by him but maturing after his tenancy terminates is referred to as *emblements*. The right exists only when: (1) the crops are annual, not perennial, having been planted or sowed by the tenant; (2) the tenancy is of uncertain duration, such as a life tenancy (sec. 1027), or a tenancy at will (sec. 1092), so that the tenant could not have known, when he planted, that the tenancy would terminate before harvest; and (3) the tenancy does not terminate by the tenant's own act, as where he quits of his own accord or violates a condition which terminates the tenancy.

1054. Tangibles ("choses in possession") v. intangibles ("choses in action"). The distinction between tangible and intangible personal property corresponds roughly to the distinction between tangible and intangible real property (sec. 1020). The terms *tangibles* and *intangibles*, though used chiefly in the law of taxation, correspond broadly to the terms *choses in possession* and *choses in action*.

Choses in possession include all things physical, such as money, gold, silver, merchandise and all other forms of personal property which are susceptible to physical possession.

Choses in action embrace all things personal which are not susceptible to physical possession and which require some form of action to reduce them to possession, such as contracts, promissory notes, checks, trade acceptances, stocks, bonds, bank accounts, and so on.

1055. Intangibles generally. Numerous forms of intangibles are considered elsewhere: bills, notes, checks, bonds, bills of

lading, warehouse receipts and trust receipts (Chapters III, IV and V); certificates of stock (Chapter VIII); insurance policies (Chapter X); and legacies and distributive shares (Chapter XIV). In this chapter we note some of the more important rules governing accounts, annuities, income, interest and usury, patents, copyrights and trade-marks.

1056. Accounts. An account is a statement of debit and credit between parties, arising out of contract or a fiduciary relation.

Open v. liquidated accounts. An *open* account is one not settled or closed, being open to future adjustment, settlement, modification or determination. A *liquidated* account is one definitely agreed upon between the parties or not subject to dispute because reduced to specific form, as by promissory note, check or otherwise.

Account current v. ordinary account. An "account current" or current account is defined as "an open or running account between two or more parties; an account not closed by settlement or otherwise. It must consist of different items of different dates, and, as held in some cases, there must be items on both sides."⁶ An account current differs from an ordinary account, in that the latter represents merely a debit, or debt due from a debtor to a creditor, as the result of one or more transactions.

Account current: when due; interest. An account current being open, and not closed by settlement or otherwise, no stipulated sum can be deemed due until a balance is struck. Upon the striking of a balance and the making of a demand, the account becomes due, and interest accrues from then on. The striking of such balance resembles an "account stated" (sec. 228).

Surcharging v. falsifying account. To *surcharge* an account means to establish that there has been an omission for which credit must be given. To *falsify* an account is to show the insertion of a wrong charge.

Joint accounts, in personalty, correspond to joint estates in realty. They are accounts held jointly, as in the case of joint bank accounts, each of the parties having an equal interest with the others, and each having an equal right to draw up to the full amount of the balance.

1057. Annuities. An annuity is a stated sum payable annually, whether in fee (sec. 1025), for life, or for years.

Annuity v. income. An annuity is distinguishable from income, in that the latter, unlike an annuity, is not necessarily fixed, and may involve uncertain deductions and expenses.

Annuity v. rent. An annuity is chargeable personally upon the grantor. Rent is a burden imposed upon or issuing from lands or chattels as compensation for use.

Pensions. Pensions are annuities granted by governments and business organizations to individuals, their heirs, representatives or beneficiaries, for

⁶ 1 *Corpus Juris Secundum* 574.

services performed, or as a social measure. *Examples:* pensions to veterans and retired employees; old age pensions.

1058. Income. The term *income*, in its broadest sense, includes all forms of return on the use of property, such as rents, profits and annuities, although annuities, as noted in section 1057, may be distinguished from income generally. The right to income on land (rent), as distinguished from land itself, is personal property, as noted in connection with leasehold estates (sec. 1053). The most common form of income is *interest*.

1059. Interest. Interest is compensation for the use of money. Interest charges may be justified on four grounds:

(a) *Sacrifice to lender:* When a person deprives himself of the use of money by lending it to another, he deprives himself of the means of purchasing property capable of producing an income, and should be compensated correspondingly.

(b) *Benefit to borrower:* One who borrows money presumably wishes it for either consumptive or productive use. In the former case, he receives the benefit representing the equivalent value of that which is capable of reproducing itself by being employed in productive enterprise. In the latter case, he employs the money borrowed for the purpose of producing income, and it is just that he should pay for the means of producing it.

(c) *Benefit to society:* It is of benefit to the community as a whole that capital be freely employed for productive purposes. When one acquires capital by saving and has no need or desire to engage in productive enterprise himself, it is of benefit to the community that such capital be available to others for the purpose of productive effort. Interest furnishes an incentive to the owner of such capital to make it available for such productive purposes.

(d) *Incentive to saving:* A mere saving of capital for the sake of saving is miserliness; but the instinct of thrift is a healthy one, since it minimizes wasteful expenditure and encourages the accumulation of a reservoir of capital to be devoted to productive purposes.

1060. Legal v. lawful interest. *Legal* interest is interest at a rate which the law applies to a debt in the absence of specific agreement. *Lawful* interest is the maximum which parties are allowed to charge. In some states, the legal and lawful rates are the same; for example, New York (6%). Other states have a legal, but no maximum or "lawful" rate. (For examples, see table on pages 532-534.)

1061. Law of what place governs interest. Whether a given interest rate is lawful or not, and what the rate should be when it is not specifically fixed in the contract, will depend on the law of the place which governs the contract. (See sec. 197.) The pertinent rules may be briefly summarized as follows:

(a) *Place where contract is made.* Ordinarily, a contract, and any interest provisions thereunder, are governed by the law of the place where the contract is made. This is especially true where the contract calling for interest provides for performance in the place where the contract is made.

(b) *Place where contract is to be performed.* When a contract calling for interest is made in one place and is to be performed in another, the law of the latter place will govern, unless the place of performance was selected for the purpose of evading the laws of the place where the contract was made.

Example: Sharpe and Long are New York residents. Sharpe, in New York (where the lawful rate is 6%), lends money at 10% to Long on a note made payable in Florida, where the maximum rate is 10%. The place of performance being obviously selected to evade the New York law, the contract, which would otherwise have been governed by the place of performance (Florida), will be governed by the place of the contract (New York).

(c) *Place where suit is brought.* If it is not clear from the contract where it was made or to be performed, the law of the place where suit is brought (the law of the "forum") will determine the validity and effect of a provision for interest.

1062. When interest begins. Interest begins to run from the time agreed upon by the parties, or in the absence of agreement, from the maturity of a debt and the making of a demand. An open and running account, being unliquidated (sec. 1056) and uncertain as to the amount due at any given time, cannot be regarded as a fixed money obligation on which interest will run. Only when an account becomes liquidated or definitely agreed upon, and a due date is established by a demand for payment, will the account mature and become interest-bearing. The establishment of an "account stated" (sec. 1056) will clearly start the running of interest at the *legal* rate, unless otherwise provided by contract.

Some statutes provide for interest from the date a wrong is committed, especially a contract wrong. Thus, in New York, if a party recovers judgment for breach of contract he is allowed interest from the date of the breach.

1063. When interest stops. Interest stops in the following situations:

(a) *On performance.* Payment of the debt or performance of an obligation generally terminates the obligation, including interest thereon.

(b) *On tender.* If, on or after due date, a debtor tenders the correct amount due and the creditor rejects it, interest stops forthwith.

Example: On July 1 Loft, after a series of transactions, tenders \$2580

to Croft, who rejects it, claiming that the correct amount due is \$2850. A year later Croft, having ascertained that Loft was right, demands \$2580 with interest from the original due date. Since Loft tendered the correct amount in the first place, he will not be liable for the interest.

(c) *On impossibility created by war.* A state of war between two countries suspends all peaceful intercourse between their respective nationals residing in their respective countries. Interest on debts as between such nationals is suspended during the war period.

(d) *On impossibility created by creditor.* Interest is suspended when the payment cannot be made because of the creditor's absence from the state without provision for a plan of payment or a person to receive it, and when the debtor is ready, willing and able to pay.

(e) *On government order.* The Federal government may, in emergency, declare a *moratorium*, or suspension in payment of debts, including interest.

(f) *On deposit in court.* When a debtor is pressed by conflicting claimants and is uncertain who is entitled to payment, he may deposit the disputed fund in court, leave the disputants to fight it out between them, and thereby absolve himself from further liability as to principal or interest.

1064. Compound interest. Compound interest is interest upon interest; accrued interest being added to principal and the whole treated as new principal for the reckoning of interest.

Rests. Rests are periodical balancings of an account, made for the purpose of converting interest into principal and charging the party liable thereon with compound interest.

Enforceability of compound interest: general rule. The law does not favor compound interest. Except when authorized by contract or statute, compound interest is generally unenforceable. However, the law distinguishes between agreements in advance to pay compound interest, and agreements to pay interest on principal which includes past due interest.

Agreements before interest due. Except when a statute expressly permits it, parties may not contract in advance for the compounding of interest or for the payment of interest upon overdue and unpaid interest installments.

Agreements after interest due. After interest has accrued, parties may agree to add the accrued interest to principal, thus making a new principal upon which interest is to be computed.

Examples:

(1) When an account has been recovered with interest at short rests, no contention may be set up as to its incorrectness on that account.

(2) The maker of a \$5000 note for one year, with interest at 6% payable quarterly, defaults in his interest payments for a whole year, then tenders a new note for \$5000 plus a year's interest. The payee demands a note for the face amount to include interest on the unpaid quarterly interest installments, insisting that such a note is enforceable. The payee's position is sound.

(3) See section 1757

1065. Usury, defined. Usury is taking, or agreeing to take, directly or indirectly, a greater sum for the use of money than that allowed by law.

Subterfuges for usury. Numerous subterfuges have been adopted to circumvent the usury statutes, among them the following:

(1) Requiring the borrower to form a corporation which is to receive the loan. This subterfuge is usually successful. See section 1067, subd. (a).

(2) Requiring the borrower to sign an instrument falsely purporting to show a valid loan, as where (a) the actual amount loaned is \$2300 and the borrower signs a note of \$2800⁷; or (b) the loan is for six months at 6% interest from July 1st, and the borrower is required to sign a note antedated six months so that the lender may collect a year's interest for a half-year loan; or (c) the lender deducts 10% interest in advance, but the loan recites interest at 6%.

(3) Charging fictitious fees, commissions or service charges, as where (a) the lender, in addition to lawful interest, requires the borrower to pay exorbitant attorney's fees for drawing up papers; or (b) the lender, as the borrower's pretended agent, collects commissions for procuring the loan (from himself); or (c) the lender imposes "service charges" to cover alleged bookkeeping, credit investigation and other "overhead" expenses in connection with the loan.

(4) Requiring the borrower, upon receiving the money, to give back part of it. ("The formal delivery of the whole with the one hand, and the retrenchment of a part of it with the other . . . is . . . simply a device to elude the statute."⁸)

(5) Selling property to the borrower on credit at an inflated price, the borrower to raise the amount of the loan by reselling the property; as where *A* lends *B* \$1000 by selling him, at a price of \$1500, stock worth \$1000, to be resold by *B* for the latter amount, *B* remaining liable to *A* for \$1500.

(6) Requiring the borrower to sell something at a low price, and to agree to buy it back later at a higher price; as where, simultaneously with a \$5000 loan at 6%, the borrower is required to sell his farm to the lender for \$2000 and to buy it back later for \$2500.

(7) Requiring the borrower to pay excessive interest under the guise of rent, as where the lender, instead of taking a mortgage on the borrower's property, buys the property and leases it back to the borrower upon rental (instead of interest) installments until the borrower "repurchases" the property (that is, pays back the loan).

(8) Requiring the borrower to buy property from the lender at an excessive price.

Example: Talbot, in obtaining a \$500,000 loan from Gibbons, is required to buy from Gibbons a \$250,000 residence for \$378,000, and stock of no value for \$80,000, making a net value received of \$292,000 against a \$500,000 note signed by Talbot.

⁷ *Schoenfelder v. Bremer*, 239 App. Div. 366, 267 N.Y. Supp. 549.

⁸ *Oyster v. Longnecker*, 16 Pa. 269, 274.

1066. Remedies and penalties for usury. The remedies and penalties for usury vary with the statutes of the different states. (See table on pages 532-534.) They not infrequently vary with the type of transaction in the same state. (See sec. 1758, subd. b.) The most common penalty is loss of all interest. In some states, usury entails a loss of excess interest only. Some statutes prescribe loss of principal and interest, others double and even treble the usurious interest, recoverable by the borrower. In some states, no penalty at all is prescribed (except for usurious loans to the needy).

Transferee of usurious contract or instrument. The assignee of a usurious contract or instrument is in no better position than the lender himself (sec. 206). However, an innocent holder in due course of a usurious negotiable instrument may or may not be immune to the defense of usury, depending upon whether (respectively) the statute merely makes the usurious interest charge illegal, or renders the entire transaction void at its inception. See section 334, subd. D (3).

1067. Exemptions from usury laws. On grounds of public policy, certain transactions involving interest charges in excess of the prescribed maximum are exempted from the operation of the usury laws. These include:

(a) *Loans to corporations.* In many states, by special statutory provision, corporations cannot plead usury; neither can an individual guarantor of a usurious corporate obligation, nor a trustee of the estate of a bankrupt corporation.

Examples:

(1) A tried to borrow money from B on second mortgage. B, to secure 12% interest, required A to form a corporation, and to assign the mortgage to the corporation. The loan was then made against the corporation's note secured by the mortgage. A then sued to cancel the mortgage for usury. The court refused to grant the relief.⁹

(2) If A guaranteed the corporate note, and the mortgage proved worthless, A could be held on his guaranty though the note was usurious, since the guarantor of a corporate obligation is in no better position than the corporation to plead usury.¹⁰

The fact that a corporation was organized for the sole purpose of taking the loan and escaping the usury laws will not enable it to interpose the defense of usury.¹¹

⁹ *Jenkins v. Moyse*, 254 N.Y. 319.

¹⁰ *Rosa v. Butterfield*, 33 N.Y. 665; *Union National Bank of Pittsburgh v. Wheeler*, 60 N.Y. 612, aff'd 96 U.S. 268; *Salvin v. Myles Realty Co.*, 227 N.Y. 51, 58; *Stewart v. Bramhall*, 74 N.Y. 85; *Union Estates Co. v. Adlon Const. Co.*, 221 N.Y. 183; *Pink et al. v. L. Kaplan, Inc., et al.*, 252 App. Div. 490, 300 N.Y. Supp. 45; *Tennant v. Joerns*, 329 Ill. 34, 160 N.E. 160; *Lane v. Watson*, 51 N.J. Law, 17 A. 117.

¹¹ *Rabinowich v. Eliasberg*, 159 Md. 655.

LEGAL AND LAWFUL RATES OF INTEREST

ORDINARY LOANS				SMALL LOANS (\$300 or less) Maximum Rate (monthly, unless otherwise stated)
State	Legal Rate (%)	Lawful Rate (%)	Civil Penalty for Usury (exclusive of any criminal penalty,	
Ala.	6	8	Forfeiture of interest; usurious interest applied on principal	8% per annum
Ariz.	6	8	Forfeiture of all interest; usurious interest applied on principal	3½%
Ark.	6	10	Forfeiture of interest and principal	10% per annum
Calif.	7	10	Three times interest paid in excess of 12%	Unsecured, 10% per annum; secured, 2½% to \$100; 2% on remainder, 2% on all loans where security is insured
Colo.	6	No limit	No penalty	10% per annum plus 10% fee plus other charges
Conn.	6	12	Forfeiture of principal and interest	3% to \$100; 2% on remainder
Del.	6	6	Forfeiture of excess	1%
D.C.	6	8	Forfeiture of interest	3½%
Fla.	6	10	Forfeiture of interest plus double interest; over 25%, forfeiture of interest and principal	1½%
Ga.	7	8	Forfeiture of interest	
Idaho	6	8	Forfeiture of interest plus recovery of twice amount of interest	
Ill.	5	7	Forfeiture of interest	
Ind.	6	8	Forfeiture of interest over 6%	3% to \$150; 2½% on remainder 3% to \$150; 1½% on remainder plus 50¢ fee on small loans (com. rate)
Iowa	5	7	Forfeiture of principal and interest; State gets 8% of judgment	
Kan.	6	10	Forfeiture of double amount of usurious interest	3% to \$150; 2% on remainder (com. rate)

LEGAL AND LAWFUL RATES OF INTEREST (Continued)

ORDINARY LOANS			SMALL LOANS
State	Legal Rate (%)	Lawful Rate (%)	(Maximum Rate monthly, unless otherwise stated)
Ky.	6	6	3½% to \$150; 2½% on remainder
Ia.	5	8	3½%
Maine	6	No limit	3% to \$150, 2½% on remainder, 25¢ minimum charge. If lender unlicensed, 12% per annum
Md.	6	6	3½%
Mass.	6	No limit	Unsecured loans, 3% to \$150; 2½% on remainder; chattel and comaker loans, 3% to \$150; 2% on remainder; other special classes (com. rate)
Mich.	5	7	3% to \$100, 2½% on remainder
Minn.	6	8	3%
Miss.	6	8	
Mo.	6	8	
Mont.	6	10	3% on loans of \$100 or less, 2½% on loans of more than \$100
Neb.	6	9	
Nev.	7	12	9% per annum plus 10% fee plus examination fee on small loans
N.H.	6	No limit	
N.J.	6	6	2% plus small fee
N.Mex.	6	10-12*	2½% 10% per annum plus 10% fee plus other charges

* Secured, 10%; unsecured, 12%.

LEGAL AND LAWFUL RATES OF INTEREST (Continued)

ORDINARY LOANS				SMALL LOANS
State	Legal Rate (%)	Lawful Rate (%)	Civil Penalty for Usury (exclusive of any criminal penalty)	(\$300 or less) Maximum Rate (monthly, unless otherwise stated)
N.Y.	6	6	Forfeiture of debt and interest	2½% to \$100; 2% on remainder
N.C.	6	6	Forfeiture of interest plus double interest	—
N.D.	4	7	Forfeiture of interest plus double interest	—
Ohio	6	8	Forfeiture of excess above 6%	3% plus \$1 fee on small loans
Okla.	6	10	Forfeiture of double interest	10%, plus various fees
Oreg.	6	10	Forfeiture of principal and interest	3%
Penna.	6	6	Forfeiture of excess interest	3% to \$150; 2% on remainder
R.I.	6	30	Forfeiture of principal and interest, except secured pawnbroker loans	3%
S.C.	6	7	Forfeiture of interest plus double interest	—
S.D.	6	8	Forfeiture of interest	—
Tenn.	6	6	Transaction void; recovery of usurious interest paid	6% per annum plus fee of 1% per month
Tex.	6	10	Forfeiture of interest plus double interest paid	—
Utah	6	10	Forfeiture of debt and interest	3%
Vt.	6	6	Forfeiture of excess interest	2½% to \$125; 2¼% on remainder
Va.	6	6	Forfeiture of interest	2%
Wash.	6	12	Forfeiture of interest charged plus double interest	3% up to \$300; 1% on remainder to \$500, minimum charge of \$1
W.Va.	6	6	Forfeiture of excess interest	3½% to \$150; 2½% on remainder
Wis.	5	10	Treble amount of usurious interest	2½% to \$100; 2% to \$200; 1% on remainder (com. rate)
Wyo.	7	10	Forfeiture of interest	—

(b) *Small loans.* Thirty-six states, besides Hawaii and the District of Columbia, have comprehensive small-loan statutes, mostly modeled after the Uniform Small Loan Law (drafted by the Russell Sage Foundation). The Uniform Law requires those engaged in lending sums of \$300 or less at rates above the maximum to be licensed, bonded and supervised by the state banking department. Rates allowed range from $2\frac{1}{2}$ to $3\frac{1}{2}$ per cent a month on unpaid balances. (See table on pages 532-534.) Violations bring civil and criminal penalties.

(c) *Special lending agencies and institutions.* Many states exempt certain lending agencies and institutions from the operation of the usury and small-loan statutes, imposing other regulations and restrictions instead. These agencies and institutions include pawnbrokers, industrial banks and loan companies, discount companies, credit unions, building and loan associations and the "personal loan" departments of regular banking institutions.

(d) *Interest taken in advance.* When maximum interest is deducted in advance, it really amounts to a usurious charge on the net loan given. However, most states allow this practice by banks and lending agencies in connection with short term loans (usually not in excess of one year).

(e) *Discount of paper other than the borrower's.* When the borrower discounts another person's note, the parties may agree on any price offered for the paper, provided this is not done as a cloak for usury. The transaction is treated, not as a loan, but as the sale of a *chose in action* (sec. 1054); that is, the borrower *sells* another person's note.

(f) *Charges payable on borrower's default.* Excessive interest, costs of collection, attorney's fees, and so on payable on the borrower's default are not usurious, because the contingency upon which these charges are based is within the debtor's control.¹²

Example: A note "with interest after date" at a usurious rate would be void. But a note "with interest at 8% after maturity" (in a state where 6% is the lawful rate) would be valid, because when an excessive rate of interest is made payable only in the event of default in payment of the principal on its due date, there is no usury, since the debtor may relieve himself of all liability by paying the principal and interest theretofore due.¹³

(g) *Miscalculation.* If usury is unintentionally charged as the result of a miscalculation, the penalties involved for usury will be withheld.

(h) *Legitimate service charges.* When service charges, such as financing or carrying charges, expenses for examination of title to property before

¹² See 66 *Corpus Juris* 202-203, citing Arkansas, Illinois, Indiana, Iowa, Kansas, Kentucky, Massachusetts, Nebraska, New York, North Carolina, Ohio, Oklahoma, Oregon, Virginia and Washington cases.

¹³ *Hunt v. Bell*, 129 Ark. 167, 195 S.W. 362; *Easton v. Butterfield Live Stock Co.*, 48 Idaho 153, 279 P. 716; *Sanner v. Smith*, 89 Ill. 123, 31 Am. R. 70; *Conrad v. Gibbon*, 29 Iowa 120; *Patrons' Mut. Fire Ins. Co. of Michigan v. Helli*, 232 Mich. 446, 205 N.W. 169; *Weyrich v. Hobelman*, 14 Neb. 432, 16 N.W. 436; *Diehl v. Becker*, 227 N.Y. 318, 125 N.E. 533; *Ward v. Cornett*, 91 Va. 676, 22 S.E. 494.

granting a mortgage loan, broker's commissions, and so on, added to the interest charged on a loan, are legitimate, not mere subterfuges for usury (sec. 1065), the loan will not be deemed usurious.

(i) *Premium for purchases on credit.* The mere fact that a seller charges a higher price for selling on credit than he does for cash is insufficient to establish usury, unless it can be shown that the transaction is a usurious subterfuge. (See sec. 1762 for an illustration.)

1068. Patents, copyrights and trade-marks. Patents, copyrights and trade-marks all represent exclusive rights confirmed by governmental grant.

Patents. A patent is a right issued in the form of "letters" by the United States Patent Office to an inventor, his heirs and assigns, granting an exclusive right, for a fixed period, to make, use and sell an invention. A person to whom a patent is granted is known as a *patentee*. Ordinary patents cover processes, machines, compositions of matter, and other articles of manufacture.

Design patents. "Design patents" cover "any new, original and ornamental design for an article of manufacture."

Copyrights. A copyright is an exclusive right to print or otherwise multiply copies of an intellectual or artistic production, to publish and sell the same, and to prevent others from doing so.

Trade-marks. A trade-mark is a name, sign, symbol or device attached to goods offered for sale, to distinguish them from similar goods and to identify them with a particular trader. (See sec. 1742, subd. a.)

Royalties represent payments or rentals made to the owner of a patent for the privilege of manufacturing or using the patented device. The term is also used to designate payments made to an author or composer under a copyright as well as payments under oil, gas, mining or mineral leases.

1069. Registration. Only in the case of a patent is registration necessary to furnish protection from infringement. This is because an inventor has no common law right to his invention.

Common law copyright. When a person writes a book, paints a picture, composes a song or makes a drawing, he is entitled, as a matter of common law right, to the exclusive ownership of his creation. He need not publish his work if he does not wish to, and he may prevent others from doing so. If he does publish his work, he loses his common law right. In the process of publication, he may, if he wishes, acquire a *statutory copyright* in place of his old common law right; but if he fails to take the necessary steps to secure a statutory copyright upon publication, he loses his right in the published work forever.¹⁴

Trade-mark registration, effect of. A trade-mark may be registered with the United States Patent Office, but such registration creates no right in the mark, since a trade-mark represents an exclusively common law right

¹⁴ *Bobbs-Merrill Co. v. Straus, et al.*, 147 Fed. 15.

derived from the fact of prior use. The Constitution gave Congress no power to pass a general trade-mark law, as it did to pass patent and copyright laws. The only effect of permitting registration of a trade-mark is to establish an official record of prior use. Such record is not conclusive. Thus, if *A* registers a trade-mark on June 1, 1948, and *B*, who has not registered, can show that he has used the same mark since May 1, 1948, *B* can prevent *A* from using the mark, since prior use, not prior registration, governs.

The Lanham Act, effective July 5, 1947, broadened the statutory recognition of commercial identification symbols so as to permit the registration not only of trade-marks, but also of "service marks," "certification marks" and "collective marks."

A *service mark* is defined as "a mark used in the sale or advertising of services to identify the services of one person and distinguish them from the services of others." It includes "the marks, names, symbols, titles, designations, slogans, character names, and distinctive features of radio or other advertising used in commerce."

A *certification mark* is defined as "a mark used upon or in connection with the products or services of one or more persons other than the owner of the mark to certify regional or other origin, material, mode of manufacture, quality, accuracy or other characteristics of such goods or services or that the work or labor on the goods or services was performed by members of a union or other organization."

A *collective mark* is defined as "a trade-mark or service mark used by the members of a cooperative, an association or other collective group or organization." It includes marks used to indicate membership in a union, association or other organization.

1070. Term of patent, copyright and trade-mark. Ordinary patents are granted for a term of seventeen years. No provision is made for renewal. Design patents (sec. 1068) are granted for terms of three and one half, seven, or fourteen years, at the option of the applicant, upon payment of fees which vary with the period. Copyrights are granted for a term of twenty-eight years, renewable for an additional period of twenty-eight years. Certificates of registration covering trade-marks, service marks, certification marks and collective marks remain in force for twenty years, subject to cancellation at the end of six years unless the registrant, within one year preceding the expiration of such six-year period, files an affidavit showing that the mark is still in use, or showing that its nonuse is due to special circumstances excusing nonuse, and not due to any intention to abandon the mark.

Amortization of patents, and so on. Patents and the cost of obtaining them should not be carried on the books of a business as a fixed asset, but rather as a "diminishing" or "wasting" asset, since they have a maximum

life of seventeen years and should be amortized proportionately. This would not apply to a trade-mark, because the validity and life of a trade-mark are not dependent upon registration. (See sec. 1748.)

Assignability of patents, copyrights and trade-marks. Patents, copyrights and trade-marks are alike assignable. (See sec. 1744, subd. c.)

1071. Who may obtain patents; what inventions are patentable. The Patent Act provides that "Any person who has invented or discovered any new and useful art, machine, manufacture, or composition of matter, or any new and useful improvement thereof, not known or used by others in this country, and not patented or described in any printed publication in this or any foreign country, before his invention or discovery thereof," may obtain a patent by taking the proper steps and paying the proper fees.

Invention must be new and useful. Either the particular thing invented must be new and useful, or else a particular combination of things, though the ingredients be old.

Effect of public use for one year or more prior to claim. If the applicant for a patent has allowed his invention to be in public use or on sale for a year or more prior to the filing of his application, he will be deemed to have dedicated it to the "public domain," and will not be granted a patent.

Priority in claims to a patent. When there are conflicting claims to a patent, the law provides that whoever first perfects the invention to a point where it can be usefully operated is the real inventor entitled to the patent, though others may have previously had the idea and made some experiments toward putting it into operation.

1072. Steps to procure patent. The inventor must make written application to the Commissioner of Patents, and file a *specification* or written description of the invention or discovery, "and of the manner and process of making, constructing, compounding and using it." Claim and specification must be signed by the inventor and attested by two witnesses. The applicant must also furnish a drawing, specimen or model to illustrate his claim. Finally, he must make oath that he believes himself to be the original or first inventor or discoverer of the art, machine, manufacture, composition, or improvement for which he solicits a patent, and that he does not know, and does not believe, that the same was ever before known or used. These papers must be accompanied with a preliminary fee in advance. The matter is then taken up and considered at the Patent Office in Washington. If, on examination, it

appears that the claimant is justly entitled to a patent, the Commissioner will issue the letters patent accordingly, at which time a final fee must be paid.

1073. Steps to procure statutory copyright. The following steps are necessary to perfect a statutory copyright:

(a) Publication of the work must be accompanied by a sufficient inscription or notice of claim. (See copyright notice on the other side of the title page to this book.)

(b) Promptly after publication, two copies of the published work must be filed in the Copyright Office, accompanied by application for copyright and statutory fee.

1074. Patent infringements. If a patent is infringed, a patentee may sue in the United States District Court for an injunction, together with an accounting for profits, and damages. The validity of a patent is frequently determined in this way, the alleged infringer raising the issue by challenging the validity of the patent.

Interference proceedings. When two or more applicants claim the same invention, an "interference proceeding" may be instituted by the Patent Office to determine, from evidence, the prior inventor entitled to the patent.

Masters. Patent litigation is often referred to a master for fact-finding purposes, because of the complex and technical character of such disputes. The master's duties are determined by the decree. Broadly, his duties are to take testimony for the purpose of determining the profits and advantages wrongfully derived from infringement. (See sec. 1751, subds. a, b and c.)

Theory of confusion. When infringing and noninfringing profits are so confused that they cannot be readily apportioned, the infringer may become liable for all profits thus wrongfully commingled. (See sec. 1751, subd. d.)

1075. Government appropriation of patents. Any officer, soldier or government employee (except employees of the United States Patent Office) may procure a patent without fee upon stating in his application that the invention may be used by the United States Government without compensation. As to all other inventions, the United States Government has the same dominant right under the police power (sec. 67) to appropriate any invention needed for the common defense, as it has in connection with all other private property. When the government appropriates or uses a patent without such right, as when the use is not necessary for a dominant governmental purpose, it is guilty of infringement, just as is any individual. The United States Government cannot be sued, however, with-

out its prior consent. For governmental infringement of a patent, a remedy lies in the Court of Claims. (See sec. 1751.)

Enemy alien patents. The United States Government may take over and exploit, without compensation to the inventor or owner, any United States patent owned by an enemy alien.

G. Personal Property: Acquisition and Disposition

1076. In general. Title to personal property may be acquired by (a) appropriation, (b) discovery, (c) creation, (d) gift, (e) sale or exchange, (f) will, and (g) operation of the law. The acquisition and disposition of personal property by sale or exchange, and by will, are discussed, respectively, in Chapters IV and XIV.

1077. Appropriation. Originally, when all things were free in nature, title to personal property was acquired by simple appropriation, represented by such modern counterparts as hunting and fishing.

Adverse possession. Title to personal property, as well as to real property, may be acquired by adverse possession (sec. 1041). See section 1740, subd. (d).

1078. Discovery: lost property. The finder of lost property acquires a title which is good as against the whole world except the true owner. He must, however, make a reasonable effort to locate the owner, though he need not incur expense in so doing. The owner may reclaim his property no matter who has it, including innocent purchasers for value (sec. 405). Policemen who find lost property may be subject to special regulations.

Example: A policeman while off duty found fourteen Liberty Bonds. He took these to the station house and turned them over to the department for the purpose of finding the true owner. The rules and regulations of the police department provided that if no claimant of lost property appeared within six months, or of lost cash within a year, the property or money would be turned over to the police pension fund. The policeman, on the ground that he was off duty when he found the bonds, sued to recover them. *Held*, he was bound by the regulations. Had he been a civilian, he would have recovered.¹⁵

1079. Creation. A person is entitled to the product of his labor, physical or mental, unless such product is made during the course and as part of his employment. In the latter event,

¹⁵ *Majewski v. Farley*, 203 App. Div. 77.

the product belongs to the employer. Examples of personal property thus acquired are too numerous to mention. They include all products of handicraft or manufacture, literary and artistic productions, patents, copyrights, trade-marks and all other evidences of creative effort.

1080. Gift: nature and essentials. A gift is the voluntary transfer, without consideration, of title in and possession of personal property. To be valid as such, it must be a consummated transaction, not a contemplated transfer or promise to make one. Thus, an *agreement to give*, like any other agreement, is ineffective without consideration, and if such agreement is supported by consideration, it is a contract, not a gift. The essential elements of a gift are: (a) competency of parties, (b) absence of consideration, (c) voluntary character of transaction, (d) transfer of possession, and (e) intent to pass title.

(a) *Parties.* The parties to a gift are *donor* and *donee*. The donor must be legally competent to make a gift, not only as to age and mental capacity, but also as to solvency. If his gift will defeat the rights of creditors, it may be set aside as an unlawful preference (sec. 1309). The donee, likewise, must be competent to accept a gift.

Examples:

(1) A gift by a bankrupt, or by an insolvent person or one rendered insolvent by the gift, may be set aside. (See sec. 1764, subd. c.)

(2) It is not within the implied powers of a partner to make gifts of firm property, and the recipient of such a gift takes it subject to the rights of the other partners. (See sec. 1764, subd. c.)

(3) Neither municipal nor business corporations have power to make gifts of their property. Corporate property is held in the nature of a trust for the benefit of creditors and stockholders (in the case of a business corporation) and taxpayers (in the case of municipal corporations). See, in this connection, section 1764, subd. c.

(4) A corporation may not accept gifts outside its powers to receive and own, neither may a political party accept campaign contributions from a corporation (sec. 830).

(b) *Absence of consideration*, from the very nature of a gift, is an essential characteristic: If the donor requires or accepts any consideration, the transaction is not a gift.

(c) *Voluntary character.* When the donor has been induced to make the gift through force, fraud, duress or undue influence, the gift may be set aside. But a gift will not be set aside merely because of favoritism or even injustice, so long as it was not induced by fraud or undue influence.

(d) *Transfer of possession.* To validate a gift, there must be immediate change of possession. This means both delivery and acceptance. The delivery may be actual (as by the manual or physical delivery of a ring), or constructive (symbolical), as by the delivery of a key, a bill of sale, a

bankbook, or a warehouse receipt. A gift is consummated by delivery (sec. 1764, subd. d).

(e) *Intent to pass title.* There must be a clear and unmistakable intention by the donor to make a gift. Delivery through inadvertence or mistake will not support a gift.

1081. *Gift inter vivos v. gift causa mortis.* A gift *inter vivos*, literally, is one between the living, as in the ordinary case where one person makes a gift to another. A gift *causa mortis* is one made in contemplation of approaching death.

Example: Desmond, on his death bed in a hospital, requests his son to bring him the contents of a deposit box, which Desmond then hands back to his son, saying, "They are yours; they are no good to me any more."

Essentials of gift causa mortis. In addition to the essentials applicable to gifts *inter vivos* (sec. 1080), gifts *causa mortis*, to be effective, must be made under the following circumstances: (1) by the donor in contemplation of his *impending* (not remote) death; (2) the donor must have died shortly after making the gift, from the cause which induced him to contemplate death; (3) the donor must not have revoked the gift prior to his death, either expressly, or impliedly (as by the fact of his recovery from the contemplated cause of death); and (4) the donee must not have died before the donor.

Gift causa mortis v. gift to take effect on death. A gift *causa mortis* is a present transfer, subject to revocability upon the happening of a condition subsequent (sec. 217), namely, the recovery of the donor. A gift to take effect upon death contemplates a future transfer, effective upon death. Such a gift is ineffective except by last will and testament (sec. 1167) or by means of a trust (secs. 1212 and 1766).

Gift causa mortis v. gift in contemplation of death. A gift *causa mortis* is one made in fear of impending death from an existing cause. A gift in contemplation of death is one made with a view to the approaching end of one's life in the normal course of things. The former is made upon the assumption that death is shortly to follow from a specific cause, an assumption that operates as a condition for the transfer, so that if the condition fails and the donor recovers, the gift is revoked. A gift in contemplation of death, however, is made upon no such condition. The gift, motivated by the expectation of death, remains absolute.

Taxability of transfers in contemplation of death. It is common knowledge that transfers in contemplation of death are motivated by a desire to avoid taxes and the expense and delay involved in the administration and distribution of decedent estates. If a transfer can be definitely shown to have been made in contemplation of death, it will be subject to a transfer tax. Contemplation of death does not mean imminent death, or apprehension of impending death, but a motivation similar to that which causes one to make a will. If the transferor reserves an income to himself on the property transferred, the transfer is not exempt from the estate tax. By Federal regulation, any substantial transfer made without consideration

within two years of death, is deemed for Federal estate tax purposes to have been made in contemplation of death unless the estate can prove the contrary.

1082. Revocability of gifts. Gifts *causa mortis*, as we have noted, are made upon certain conditions, upon the nonfulfillment of which the gift is revoked. Gifts *inter vivos*, ordinarily, are absolute and irrevocable. To this rule, however, there are two exceptions:

(a) *Force, fraud, and so on.* As pointed out in section 1079, if the donor has been induced to make the gift through force, fraud, duress or undue influence, the gift is revocable.

(b) *Conditional gifts.* Conditional gifts are revocable if the conditions are not fulfilled.

Example: Gift made in contemplation of marriage, which does not take place.

Engagement rings. "The gift of an engagement ring is conditional, and as a general rule the donor is entitled to reclaim it if the engagement is broken.¹⁶ The rule generally applies where the engagement is broken by the donee,¹⁷ where the engagement is terminated by mutual consent,¹⁸ or where the marriage does not occur because of disability of either party which is recognized by law,¹⁹ or because of the death of the donee."

1083. Title by operation of law. As more fully discussed in Chapter XIV, when a person dies "intestate," his property passes "by operation of the law" to certain relatives of the deceased in a given order. If a person becomes bankrupt (Chapter XVI), all his property, save for certain personal exemptions, passes by operation of law to a trustee for the benefit of creditors. A person's property may also be taken from him by legal process, as by attachment, and by levy and sale under execution of a judgment (sec. 73).

Questions and Problems for Review

1. What meanings has the term *property*? *NY Nov. 1932 (6)*
2. What are the two classes of property? What subdivision may be made of these classes? Describe briefly. *NY June 1916 (4)*

¹⁶ *Sloin v. Lavine*, 11 N.J. Misc. 899; *Ruehling v. Hornung*, 98 Pa. Super. 535.

¹⁷ *Hutchinson v. Kernitzky*, 23 N.Y. Supp. 2d 650, appeal denied 260 App. Div. 628, 24 N. Y. Supp. 2d 1013.

¹⁸ *Wilson v. Riggs*, 267 N.Y. 570, aff'g 243 App. Div. 33.

¹⁹ *Ruehling v. Hornung*, 98 Pa. Super. 535. (The quoted excerpt and citations are from 38 *Corpus Juris Secundum* 850-851.)

3. Classify estates as to the time when enjoyment begins. What is the remainder? *NY June 1916 (12)*

4. With regard to realty, explain (a) tenancy in common, (b) tenancy by entirety, (c) tenancy in severalty. *NY Nov. 1928 (5)*

5. Distinguish between an easement and a license. In what ways may an easement be acquired? In what ways may it be lost or extinguished? *NY Nov. 1934 (8)*

6. Mention *two* methods of acquiring title to real property. When does perfect title result? What is an abstract of title? *NY Nov. 1934 (10)*

7. Can a vendor, in wrongful possession, convey good title to property? Explain. *NY Jan. 1922 (14)*

8. To what kind of property does a wife's right of dower attach? On the death of the husband, what benefits accrue to the widow by reason of this right? *NY Jan. 1926 (3)*

9. What is dower and to what does the claim for dower usually extend? *NY Jan. 1922 (10)*

10. What essentials must be present in "curtesy estate" in realty? *NY Nov. 1929 (10)*

11. State two differences between the right of dower and the right of curtesy. To what class of property does each relate? *NY May 1927 (1)*

12. Give form of option agreement for sale of real estate. *NY Jan. 1919 (12)*

13. What remedy has a vendor of realty, sold on the installment plan, if the purchaser fails to make payment as agreed, time being the essence of the contract? *NY Jan. 1920 (11)*

14. Smith executed a valid contract with Hess whereby he agreed to convey certain real estate to Hess. Hess made a payment on account and incurred expense in an examination of the title. While the contract was in force, Smith conveyed the real estate to another person at a price exceeding that specified in the contract with Hess. What remedies has Hess? *AI May 1931 (11)*

15. When does a deed conveying real estate take effect? Is there any legal presumption as to the time a deed took effect, and if so, is this presumption subject to rebuttal? Give reasons. Define escrow as used in connection with a deed. *NY June 1932 (8)*

16. What is the difference, from a legal standpoint, between an account current and an ordinary account of a customer or creditor? When is an account current due? Under what circumstances does it cease to be an account current? What rules apply as to interest on an account? *NY June 1917 (4)*

17. Define and explain briefly (a) patents, (b) copyrights and (c) trade-marks. *AI Nov. 1934 (7)*

18. Define: (a) interest, (b) usury. What is the penalty for usury in this state? Name some transactions that are exempt from the operation of the law. *NY June 1918 (14)*

19. Give three or more reasons that justify charging interest. *NY June 1917 (5)*

20. When an account has been recovered with interest at short rests, what contention may be set up as to its incorrectness? Why? *NY June 1917 (6)*

21. The maker of a promissory note for \$5000 for one year at 6% interest payable quarterly, defaults in his payment of interest for the whole period. When the note is due, he tenders the face of the note plus a year's interest. The payee claims interest on the quarterly installments of interest unpaid. The contention of the maker is that this is a demand for interest on interest, and therefore contrary to law. Is this contention valid? Give reasons. *NY Jan. 1916 (5)*

22. Mark Talbot was insolvent. In order to obtain a loan of \$500,000 from Clark Gibbons, Talbot was compelled by Gibbons to purchase from him, for \$378,000, a residence property known to be worth \$250,000, and certain corporate stock of no market value for \$80,000. Talbot signed a note payable to the order of Gibbons carrying interest at the legal rate of 6%.

(a) At maturity, will the note be enforceable by the payee?

(b) At maturity, will the note be enforceable by a holder in due course? *AI Nov. 1932 (4)*

23. A trustee in bankruptcy of a corporation refuses to recognize the validity of the claim of a creditor on a promissory note, on the ground that the note is usurious. Is the note good against the estate of the bankrupt? Explain. *NY Jan. 1917 (8)*

24. A, an individual, attempted to borrow money from B on a second mortgage. B, in order to secure 12% interest, compelled A to incorporate his business. The corporation then issued its note and B discounted it at 12%. The note which was guaranteed by A was not paid at maturity. What amount can B collect? *NY June 1923 (10)*

25. What is the value at maturity of a promissory note of a solvent maker, for \$1000, dated June 1, 1932, due June 1, 1933, with interest after date at 8% per annum? Explain. *NY Apr. 1933 (7)*

26. Define the act of making a gift and mention the essential elements. *NY Oct. 1933 (3)*

CHAPTER XII

Landlord and Tenant

1084. **Scope of chapter.** In this chapter we consider the nature and essentials of the landlord and tenant relation; the various kinds of tenancies; the rights, duties, obligations and incidents of the landlord and tenant relation, implied in law or specified in a lease; the form and standard provisions of a lease; and the different ways in which a tenancy may be terminated.

A. Nature and Essentials of Landlord and Tenant Relation

1085. **Origin, nature and essentials.** The relation of landlord and tenant originated as an outgrowth of the feudal system, under which a serf or less than freeholder, the forerunner of the tenant, *held* or *possessed* the land of his feudal lord, as distinguished from a freeholder, who *owned* the land he occupied. The relationship, from its nature, concerns lands: There can be no *landlord* of personal property.

Definition. The relation of landlord and tenant may be defined as that which arises from a contract whereby, for a consideration, one person, known as tenant, occupies the real property of another, known as landlord, exclusively, with his permission, and in subordination to his rights; the landlord retaining a reversion, the contract being termed a lease, and the consideration being designated as rent.

Essentials. The foregoing definition discloses five essentials to the landlord and tenant relation: (1) a contract, (2) exclusive possession, (3) a subordinate holding, (4) a reversion in the landlord, and (5) reservation of rent. (The subject of rent is discussed in sec. 1104.)

1086. **The contract.** Like all contracts, a lease must possess all the contract requisites (sec. 106). The *parties* (*landlord* and *tenant*, or *lessor* and *lessee*) must be capable in law of making a contract. There must be *consideration* (rent to the landlord, possession to the tenant). There must be *mutual assent*. (A "squatter," for example, occupying without the landlord's consent, is not a tenant.) Finally, there must be

valid subject matter. A lease is void if its object or purpose is void. The object or purpose may be void when the lease is made, or it may become so later.

Examples of leases void when made:

(1) Lease for gambling purposes.

(2) "Black market" lease, that is, at a rental above a maximum fixed by an emergency rent law.

Example of lease becoming void after leasing. A lease provided that the premises were to be used and occupied for a liquor saloon and no other purpose. *Held*, the lease was terminated by a law prohibiting the sale of intoxicants.¹

An owner who leases premises for an unlawful purpose cannot recover rent for the use of the premises and in addition may become criminally liable for violating the law.

An oral lease may be voidable under the statute of frauds (sec. 182), as where the statute requires every leasing of real property for over a year to be evidenced by a writing.

1087. Exclusive possession. Not everyone who occupies another's real property, even by consent, is a tenant. To be a tenant, one must have *exclusive possession*, not mere use alone. That is, one must have an *estate*, or *interest in the land*. The following classes of persons, lacking exclusive possession, are not tenants:

(a) *Licenses.* A license is a mere privilege or permission to use lands; for example, the license of a contractor while he is erecting a building upon your land, or of an advertiser who pays you for the privilege of erecting and maintaining a sign on the roof of your building. In the latter case, if the advertiser failed to remove his sign at the end of a year, he could not be treated as a "holdover tenant" for another year, because he is a mere licensee.²

(b) *Boarders and lodgers.* Unlike a tenant, a boarder and lodger *occupy*, but do not *possess* the rooms they hire: Possession is in the proprietor.³ Hence, for an unpaid bill, a hotel proprietor or a boardinghouse keeper may hold a guest's or boarder's trunk under a *possessory lien* (sec. 1136); but a landlord, lacking possession, has no possessory lien, hence no right to hold a tenant's property for unpaid rent, except where the common law remedy of "distress" (sec. 1104) is still recognized.

¹ *Kaiser v. Zigler*, 115 Misc. 281.

² *United Merchants' Realty & Improvement Co. v. N.Y. Hippodrome*, 133 App. Div. 582.

³ *People v. Vaughan*, 65 Cal. App. 2d Supp. 844, 150 P. 2d 964; *Carroll v. Cooney*, 116 Conn. 112, 163 A. 599, 600; *Washington Realty Co. v. Harding* (D.C.), Mun. App., 45 A. 2d 785; *Brin v. Sidenstucker* (Iowa), 8 N.W. 2d 423; *Marden v. Radford*, 229 Mo. App. 789, 84 S.W. 2d 947.

Example: The occupant of office space under a lease, and of rooms in a hotel, in the absence of the "distress" remedy, is not subject to seizure of his belongings for rent delinquency under the lease, but is subject to such seizure for nonpayment of his hotel bill. (See sec. 1772.)

(c) *Agents, employees, servants, and so on.* An agent, employee or servant who occupies a principal's or employer's property as part of his employment contract, is not a tenant, but a mere licensee, and may be removed at any time.

Examples: Clergymen, schoolteachers, superintendents, janitors, watchmen or caretakers who occupy premises incidentally to the discharge of their duties.

1088. Subordinate holding. As the freeholder in feudal times owed absolute allegiance to his lord from whom he held his lands, so a tenant today owes allegiance to the title of his landlord. Once he recognizes the landlord's title by accepting a tenancy from him, he cannot thereafter dispute it, or set up a superior claim to it.

If a stranger comes in, and by suit against the tenant asserts a title superior to his landlord's, the tenant must promptly notify the landlord, or he may be made to forfeit three years' rent for failure to do so.

1089. Reversion in landlord. A reversion, as noted (sec. 1029), is the balance of interest which one retains in an estate, after disposing of part of it to another. Hence, a leasing forever is inconsistent with the landlord and tenant relationship. If a five-year tenant with four years to go transfers possession of the premises to a third party for the full remainder of his term without reversion to himself, the transaction is an *assignment* (sec. 1114), not a sublease.

B. Kinds of Tenancies

1090. Less than freehold estates generally. We have already briefly mentioned, in the discussion of estates, the various classifications of *less than freehold* estates (sec. 1127). As pointed out, such estates are personal property interests, known as "chattels real." They relate to *possession* rather than *ownership*. They include: (1) estates for years, or tenancies for a fixed period, (2) tenancies at will, (3) tenancies by sufferance, (4) periodic tenancies and (5) statutory tenancies.

1091. Tenancies for fixed period ("estate for years"). The term *estate for years* is not to be taken literally. Tenancies for years include all tenancies wherein the term or duration of

the estate, however short, is definite and fixed. The tenancy need not be for a given number of years, or even for a year, but may be for a month, or a week, or even a day.

1092. Tenancies at will. A tenancy at will is one for an uncertain period, which is held at the will of either the landlord or the tenant. Either party has a right to terminate the tenancy whenever he pleases. Unless thus terminated, it continues indefinitely. At common law, a tenancy at will could be brought to an end by either party at any time without notice. The tendency of modern decisions, however, is to require notice before such a tenancy can be terminated. In New York and a number of other states, the landlord must give a tenant at will thirty days' notice in writing if he desires to terminate the tenancy.

1093. Tenancies by sufferance. A tenancy by sufferance exists when a tenant has entered into possession rightfully, but holds over wrongfully. Strictly speaking, he is not a tenant at all; yet since he has come into possession rightfully, he cannot be treated as a trespasser. He simply stays in possession until the landlord gets him out. Under the statute in many states, a tenant at sufferance, like a tenant at will, cannot be removed except upon thirty days' notice in writing.

1094. Periodic tenancies. Periodic tenancies grew out of tenancies at will. Under the common law, if a tenant at will paid his rent every year, half-year, quarter, or month, and nothing was said to the contrary, the term would continue to run from year to year, from half-year to half-year, from month to month, and so on, depending upon the interval of rent payment. Later, the term took on a fixed character so far as *the particular period* was concerned, that is, it was regarded as certain for a year, a half-year, a month, and so on, but uncertain as to *how many* years, half-years, months, and so on, the entire tenancy might run. Hence, neither landlord nor tenant could terminate the tenancy *within* the given period, but could, on notice, cause it to terminate at the *end* of any given period. Such a tenancy, running from period to period, got to be known as a periodic tenancy. Since it may continue indefinitely, it differs from an estate for years, which is for a fixed term. And since it cannot be terminated at *any* time, but only at the end of a given period, it differs from an estate at will, which can be terminated at any time upon proper notice. A periodic ten-

ancy, unlike a tenancy at will, is not necessarily terminated by the death of the parties, since it is not solely dependent upon the will of the parties, but creates a leasing which, although indefinite as to the number of periods for which it may run, is nevertheless definite so far as each period is concerned. Hence, if a tenant from year to year dies in the middle of the year, his estate may get the benefit of the balance of the yearly period, unless there has been an express agreement to the contrary.

In practice, the distinction between tenancies at will and periodic tenancies is rapidly disappearing. In numerous jurisdictions, the dividing line between the two is indistinct.

1095. Statutory tenancies: emergency rent laws. What virtually amounts to a statutory tenancy results from a condition where, because of a housing emergency, the state steps in and passes a law depriving a landlord, despite the expiration of a lease, of the right to remove a tenant so long as he pays a reasonable rent. Such an estate is in no way dependent upon the landlord's wishes, but is solely the creature of a statute. Its justification lies in the "police power" or dominant right of the state to take such measures as may be necessary, in any given emergency, to protect the public welfare (sec. 67). Emergency laws continuing tenancies beyond the period fixed by contract or lease were necessitated by housing shortages during and after the first and second world wars. In addition to various state laws, Congress passed an act during the second world war⁴ establishing an Office of Price Administration (OPA), the Administrator of which, in addition to his other powers, was given the right to regulate renting or leasing practices in areas to be fixed by him, including practices relating to the recovery of possession of premises. Under this general power, removal of a tenant, notwithstanding the expiration of his lease, was authorized only under certain conditions⁵ upon certification of the Administrator.

C. Rights, Duties and Incidents of Landlord and Tenant Relation

1096. In general. The rights, duties and obligations as between landlord and tenant are determined by the covenants

⁴Emergency Price Control Act of 1942.

⁵For example, that the landlord, in good faith, needed the premises for his own immediate use and occupancy.

between them. These may be implied by law, expressed in a lease, or both. Most of these rights, duties and obligations are customarily expressed in a lease.

1097. Quiet enjoyment. When a landlord lets premises he impliedly warrants (a) that he has a paramount right to let the premises, and (b) that neither he, nor any person, nor any condition subject to his control, shall disturb the tenant's right to absolute possession of the premises. These warranties, which the law implies whether they are expressed in a lease or not, constitute the landlord's covenant of "quiet enjoyment."

Eviction. Eviction is a breach of the landlord's covenant of quiet enjoyment. Originally it meant putting a tenant out of possession, for whatever cause. Eviction may be *actual* or *constructive*.

1098. Actual eviction. Actual eviction is ousting a tenant from possession by some direct act of the landlord, as by forcible expulsion, entry and interruption of possession, locking the tenant out, leasing the premises to another tenant and giving him possession as against the first tenant, or preventing a tenant from using halls, elevators or other means of access.

1099. Constructive eviction. Constructive eviction exists when the tenant is forced to quit the premises, not because of an act which the landlord *commits*, but rather because of an act or condition (under his control) which he *permits*.

Examples: Any nuisance on the same or adjoining premises over which the landlord has control; stench from dead rats in the walls of the building; disorderly conduct of other tenants in the building without reasonable effort by the landlord to prevent it; failure to furnish heat, steam or hot water when the landlord is required to do so.

Acts or conditions beyond the landlord's control do not constitute constructive eviction; for example, a nuisance in the neighborhood which the landlord is powerless to abate.

Necessity that tenant promptly quit premises. If a tenant claims constructive eviction, he must promptly quit the premises. He cannot claim he was forced out, while he remains in.

1100. Eviction by paramount title. If, after a landlord leases premises, someone else proves that he has a superior title to the premises, and forces the tenant out, the latter has a right of action against the landlord for the consequent damage. This is the type of situation which the landlord's covenant of quiet enjoyment (sec. 1096) clearly contemplates.

1101. Eviction by mortgage foreclosure. When a tenant leases premises on which a third party holds a mortgage which

he subsequently forecloses, the tenant, if forced out by such foreclosure, may sue the landlord for the eviction, unless the premises were leased "subject and subordinate" to the mortgage. When a tenant signs a lease which contains a provision that it is "subject and subordinate to the lien of the mortgages now on the premises, and to all advances heretofore made or hereafter to be made upon the security thereof, and subject and subordinate to any mortgage or mortgages which at any future time may become a lien on the premises," he signs a blanket surrender of the premises in advance in case foreclosure proceedings should be brought in connection with any existing or future mortgages upon the property. Even if the lease contains no such provision, the tenant is subject to any *prior* mortgage on the premises, provided (a) the tenant has actual knowledge of the mortgage, or (b) the tenant has constructive knowledge of the mortgage by reason of its having been recorded (sec. 1051).

Example: X mortgages property to Y and thereafter leases it to Z. If Y forecloses the mortgage and makes Z a party to the foreclosure proceedings, he may terminate Z's tenancy by the judgment of foreclosure, provided Z had actual or constructive knowledge of the prior mortgage. (See sec. 1770, subd. (d).)

1102. Complete *v.* partial eviction. Complete eviction takes place when a tenant is ousted from the entire premises; partial eviction, when a tenant is evicted only from part of the premises. The Court has held that when partial eviction is *actual* (sec. 1098), the tenant may remain on the premises, yet not pay *any* rent so long as the partial eviction continues, "because the landlord is not permitted to apportion his own wrong."⁶

1103. Covenant not to dispute landlord's title. So long as a tenant remains in undisturbed possession, he cannot dispute the landlord's title. In some states (New York, for example) if a third party claiming a title superior to the landlord's serves a process on the tenant in which such claim is set forth, the tenant must forthwith notify the landlord of such claim or *he forfeits the value of three years' rent.*

⁶ *Fifth Avenue Bldg. Co. v. Kernochan*, 221 N.Y. 370. See also, *Collins v. Karatopsky*, 36 Ark. 316; *Skaggs v. Emerson*, 50 Cal. 3; *Graham v. Anderson*, 3 Del. 364; *Hoagland v. New York, etc., R., Co.*, 111 Ind. 443, 12 N.E. 83, 13 N.E. 572; *McKenzie v. Lexington (Ky.)* 4 Dana 129; *Ravet v. Garelich*, 221 Mich. 70, 190 N.W. 637; *Edmison v. Lowry*, 3 S.D. 77, 52 N.W. 583; *Powell v. Merrill*, 92 Vt. 124, 103 A. 259; *Tunis v. Grandy*, 22 Gratt. (63 Va.) 109.

1104. Rent. Rent is compensation in money or other value paid by a tenant to his landlord for the use of premises. The obligation to pay rent, like the landlord's covenant of quiet enjoyment and the tenant's covenant not to dispute the landlord's title, is implied in law, whether it is mentioned in the lease or not. Usually, of course, it is fixed in the lease. If there is no specific agreement for rent, the law will imply an obligation by the tenant to pay reasonable value for "use and occupation."

When rent is payable in advance. It is customary in a lease to provide that rent shall be payable monthly or at some other interval in advance. In the absence of such provision, rent is not payable in advance.

Rent falling due on a legal holiday. It has been held that rent falling due on a legal holiday other than a Saturday is due on that day, not the next succeeding business day.⁷

Rent paid to an agent after the landlord dies may have to be paid over again (sec. 582).

Remedies for nonpayment of rent. When a tenant fails to pay his rent, the landlord may (1) sue for the rent, as for any other debt, or (2) bring a *summary proceeding* (sec. 1123) to dispossess the tenant, or, in some jurisdictions,⁸ may do both in one proceeding. Ordinarily, as pointed out in sec. 1087, subd. (b), a landlord, unlike a hotel or boardinghouse keeper, not having possession, has no possessory lien (sec. 1136) against the tenant's furniture and chattels, hence cannot attach or levy upon them for nonpayment of rent, at least, not until he has first brought suit and obtained a money judgment against the tenant. An exception to this rule is found in states which recognize the common law right of "distress."

Distress proceedings. Under the common law, a landlord may seize movables found on premises when rent is in arrears, and may hold them until the rent is paid. This remedy is known as *distress*. It has been abolished or greatly curtailed in a majority of the states. Under the common law, *any* movables found on the premises (whether the tenant's or not) were subject to distress; today, in states which still recognize the remedy, only a tenant's own chattels are subject to it. Also, the remedy may no longer be enforced by direct action of the landlord, but by law-enforcement officers acting under a warrant or court order.

1105. Description of premises. A tenant gets the use only of such premises as are described in the lease. This includes all facilities necessary to such use: entrances, exits, hallways, elevators, and so on. A lease of an entire floor includes the right to use the outside wall of the floor, unless the lease specif-

⁷ *Walton v. Stafford*, 162 N.Y. 558.

⁸ Among them, California, Illinois, New York and Pennsylvania.

ically provides to the contrary. (Leases frequently limit the right to use signs on the outside of a building.)

1106. Use of premises. When a lease is silent on the purpose for which the premises are to be used, the lessee may use the premises for any legal purpose not constituting *waste* (sec. 1027). Most leases contain limitations on the purpose for which the premises may be used; such as covenants in residence leases restricting the use of premises to residential purposes; covenants in business leases that the premises are to be used for a given business purpose and no other; covenants against nuisances, the use of premises as a boardinghouse, and so on.

1107. Fitness for use. The law implies no covenant by the landlord that premises are *fit* for any particular purpose, even if the lease provides that the premises are to be used for a given purpose. If a tenant wishes to be protected by such covenant, he must have it inserted in the lease. However, a landlord is liable for fraud in knowingly making false statements about the condition of premises, or in failing to make disclosure when he should, as by renting premises infected with a contagious disease without disclosing such fact,⁹ or by failing to disclose a dangerous condition of the building leased, which caused public authorities to condemn it shortly after the tenant took possession.¹⁰

1108. Repairs. Contrary to common belief, the duty to make repairs is on the tenant, not on the landlord. To this rule, however, there are certain exceptions:

- (a) When the landlord assumes the duty by lease.
- (b) When the duty is imposed on the landlord by statute, as by tenement house or emergency rent legislation (sec. 1094).
- (c) When the landlord has exclusive control of portions of premises used in common, as in the case of common stairways, hallways, roof of buildings, and so on.
- (d) When the repairs are of a structural nature.

Painting, decorating, and so on. The question of who must do the painting and decorating, how and where it must be done, and so on, is usually a matter that should be specified in the lease, otherwise the landlord has no duty in the matter. However, multiple dwelling and tenement house statutes frequently impose a duty on the landlord in these matters, in the interests of sanitation. For example, the New York Multiple Dwelling

⁹ *Manor v. Sharon*, 112 Mass. 477.

¹⁰ *Steefel v. Rothschild*, 179 N.Y. 273.

Law provides¹¹: “. . . The interior surfaces of walls and ceilings of any multiple dwelling . . . shall be painted or, if papered, shall be repapered or painted and the ceilings shall be rekalsomined, repapered or repainted whenever necessary, to keep said surfaces in a sanitary condition.” (See sec. 1775.)

1109. Destruction or substantial injury to premises. At common law, the destruction of leased premises, or any damage to them, substantial or otherwise, did not relieve the tenant of his obligation to pay rent—though the premises became wholly untenable—unless such destruction or damage was due to the landlord's neglect. This rule has been modified by statute in most states. When a building is completely or substantially destroyed so as to be rendered untenable, as in the case of a fire, the tenant may quit or surrender possession without further obligation to pay rent, unless (a) the lease otherwise provides; or (b) the damage or destruction is due to the tenant's fault.

1110. Fixtures. The term *fixtures* has already been defined in sec. 1025. As there noted, fixtures may be *real* or *personal*, depending, respectively, upon whether they are affixed with or without intent of permanence. In the former case, the fixture becomes part of the realty and cannot be removed without the consent of the landlord. In the latter case, the fixture, being personalty, may be removed.

Essential test. The essential test of removability of a fixture is whether or not its annexation was intended to be permanent. Such intent may be *express*, as where specific provision concerning the ownership of the fixture is made in a lease or other contract; or it may be *implied* from the circumstances of the annexation (such as the character of the annexation itself, the purpose of the annexation, its adaptability to permanent use in connection with the premises, or the question of whether its removal will seriously injure the premises). No one of these circumstances is necessarily conclusive: Intent in each case must be determined from *all* the circumstances. Some fixtures are so clearly intended for permanent use that there can be no questioning their nature as real fixtures; for example, the installation of a bathtub. Other fixtures are so clearly intended for temporary use that there can be no questioning their nature as personal fixtures; for example, readily removable machinery used by a tenant in his business.

In many cases, however, it is more difficult to determine the probable intent governing the annexation. In such cases, intent must be determined from all the surrounding circumstances.

Test as between vendor and vendee. When the annexation is by the

¹¹ Sec. 80.

owner, who then sells the property, the question as between seller and buyer (when both claim the fixture) will usually be resolved against the seller, because annexation by an owner is presumed to be permanent. (See sec. 1731.)

Example: The owner of a house equips his windows with Venetian blinds. In the absence of special circumstances showing the contrary, the blinds will be presumed to go with the house.

Test as between landlord and tenant. Since the tenant's use is temporary, annexations made by him are presumed to be for temporary use in connection with the premises, unless there is an express agreement to the contrary in the lease, or an implied intent of permanence shown by the character of the annexation (as by building a fence around the house or adding a porch to it). See section 1731.

Example: If a tenant installs Venetian blinds, the presumption is that they are to remain his (in the absence of agreement to the contrary in a lease, or of other facts showing an intent to disclaim ownership).

Trade fixtures. Trade fixtures are those annexed or installed for the current business purposes of the tenant and hence obviously not intended for permanent annexation, so that they cannot be deemed part of the realty unless a contrary intention is expressed by the parties. Illustrations of trade fixtures are as follows: mirrors, chairs, and similar installations in a barber shop; electrical ice boxes in a meat market; sewing machinery, cutting tables and benches in a clothing establishment. These, even though affixed to the premises, will be deemed property of the tenant unless otherwise expressly agreed. Since trade fixtures in the absence of agreement to the contrary are deemed the property of the tenant, they are removable by the tenant at the expiration of the lease provided they can be removed without substantial injury to the premises.¹²

Ornamental fixtures. Ornamental fixtures are those affixed by a tenant to a dwelling house for purposes of ornamentation, not being intended, as a rule, for permanent annexation, and being easily separated from the premises without injury thereto; as, for example, special lamps and lighting fixtures, easily removable bathroom appliances, removable mantelpieces, and so on.

Machinery; heating and cooling systems, and so on. Whether or not machinery, heating and cooling systems, and similar equipment become part of the building in which they are installed depends upon intent as disclosed by (1) character of the annexation and (2) adaptability for use in the particular premises where they are installed. Each case must be judged on its own facts in the light of these tests. A tenant will bear these tests in mind in distinguishing between his permanent, and his "wasting" assets. If a fixture is removable, it constitutes a fixed or permanent asset (except for depreciation); if it is not removable, but becomes the property of the landlord on termination of the lease, it represents a diminishing or wasting asset.

¹² *Carte-Caldwell v. Berryhill*, 112 P. 2d 370; *Hopwood v. Green*, 34 N.E. 2d 559, transferred 375 Ill. 167, 30 N.E. 2d 656.

Examples:

(1) A tenant installs machinery in a building for the purpose of running a mill. The machinery is put on solid foundations and attached to the property. The Court would probably rule that such fixture became part of the realty. Hence a mortgage foreclosure of the premises would include the machinery.

(2) A tenant in possession of a factory under a lease replaced an old engine belonging to the landlord with a new one belonging to himself, and stored the old engine, intending to put it back on expiration of the lease. When the lease expired, the landlord claimed the new engine. *Held*, for the tenant.¹³

(3) A turbine pump installed in a theatre building as part of the theatre's cooling system was held to constitute a real fixture and to have become a permanent part of the premises.¹⁴

(4) A refrigerating system was installed in a building in such manner as to indicate its adaptability to the realty. From the manner of its installation, and from the fact that damage would be caused if the system were removed, the owner was presumed to have intended that the system installed should become part of the building itself. The court therefore declared this a real fixture.¹⁵

(5) An oil heating system was installed in a building in place of a coal heating system. The oil tank was cut in half and then placed in position and welded. The rest of the machinery was also placed in position and then bricked up. *Held*, that the oil heating system and the bricking became part of the realty.¹⁶

(6) A water heater actually attached to a building and connected with water pipe was held "immovable."¹⁷

(7) But a gas burner attached by coupling to a gas pipe extending from the furnace and removable without injuring the premises was declared personalty.¹⁸

(8) See section 1777.

House fixtures. House fixtures, such as *gas fixtures, furnaces, ranges, ornamental mantels, fireplaces, installed hat racks*, and similar things annexed to a house as part of it, and completing the interior finish of the house, are fixtures. Their adaptability for permanent use as part of the house shows conclusively that they were annexed with intent to make them fixtures.¹⁹ Radiators are held to be real fixtures.²⁰ Gas pipes are held to be part of the realty to which they are annexed, but chandeliers and gas

¹³ *Andrews v. Day Button Company*, 132 N.Y. 348.

¹⁴ *Rinbrand Well Drilling Co. v. L. & H. Theatres*, 20 A. 2d 358, 126 N.J.L. 446.

¹⁵ *Dolan v. Doherty*, 242 App. Div. 671, 272 N.Y. Supp. 892, modified 242 App. Div. 897, 275 N. Y. Supp. 1004.

¹⁶ *Nicklas v. Pickford*, 160 Misc. 254, 289 N.Y. Supp. 174.

¹⁷ *Scott v. Brennan*, 3 La. App. 452.

¹⁸ *Delaware Hill Development Co. v. Delaware Building Corp.*, 137 Misc. 672, 244 N.Y. Supp. 324.

¹⁹ Walsh, *Real Property*, sec. 45.

²⁰ *Keeler v. Keeler*, 31 N.J. Eq. 181; *Capehart v. Foster*, 61 Minn. 132.

fixtures screwed on such pipes for the purpose of using the gas for lighting or heating purposes are treated as personal property.²¹ This rule includes gas ranges in residences and apartment houses.²²

House furnishings: carpets, shades, radio sets, and so on. Hall carpets, window shades, curtain poles and ash cans are held to be personal property and not real fixtures.²³ Radio sets, though connected up by the tenant to house wires, are personalty.

Failure by tenant to remove fixtures. A tenant must remove his fixtures during the term of his tenancy, or, if he holds over, before quitting possession of the premises as tenant. If they are on the premises thereafter, they merge with the realty and become the property of the landlord, on the theory of an implied gift. Of course this does not apply where the landlord agrees that the tenant may return at a later time to remove his fixtures. (See sec. 1776.)

1111. Insurance. In the absence of express agreement in the lease, there is no implied covenant on the part of the tenant to insure the premises. Business leases, especially for the longer terms, frequently provide that the tenant must insure the premises for the landlord's benefit or must keep up insurance already in force, and that in case of loss the insurance money must be applied to rebuilding.

1112. Taxes. Unless there is a provision in the lease to such effect, the tenant is not responsible for taxes on the premises. Long term leases usually require the tenant to pay taxes. If taxes remain unpaid for a given period, a tax lien arises (sec. 1160). The foreclosure of a tax lien may wipe out a tenant's interest.

1113. Condemnation of leased premises. When premises are condemned under the power of eminent domain (sec. 68), the compensation paid in condemnation proceedings, unless otherwise provided in the lease, must be apportioned between the landlord and the tenant upon the basis of the value of their respective interests; the tenant, for the value of his *present estate* (sec. 1029), and the landlord, for the value of his *reversion* (sec. 1029). Many leases give the landlord the exclusive right to moneys paid in such cases.

1114. Assignment and subletting. An assignment differs from a sublease in three respects:

²¹ *Vaughen v. Haldeman*, 33 Pa. St. 522.

²² *Jarechi v. Philharmonic Soc.*, 79 Pa. St. 403; *McKeage v. Hanover Fire Ins. Co.*, 81 N.Y. 38; *Central Union Gas Co. v. Browning*, 210 N.Y. 10.

²³ *Manning v. Ogden*, 70 Hun. 399; *Cosgrove v. Troescher*, 62 App. Div. 123.

(1) *As to interest retained by tenant.* An assignment transfers a tenant's entire interest in the premises. A sublease constitutes the tenant a landlord as to a subtenant. If the sublessee fails to pay rent, the tenant may dispossess him. An assignor has no such remedy against his assignee.

(2) *As to how the interest passes.* An assignment may be effected by act of parties (as by contract) or by operation of law (as by death or bankruptcy). A subletting can be effected only by act of parties.

(3) *As to liability on lease.* An assignment creates a *privity of estate* between the original landlord and the assignee. This means that the assignee steps into the shoes of the tenant-assignor and becomes bound by the covenants of the lease to the extent that they "run with the land" but no further. That is, the assignee is not bound by any personal obligation or promise, unless he personally assumes the obligations of the assignor. But so long as the assignee remains in possession, he remains bound by the covenants of the lease, including the covenant to pay rent, not to commit waste, to pay taxes, to make repairs, not to assign or sublet, to insure the premises, and so on. If he fails to pay rent or violates any of the other covenants, the assignor becomes liable as surety, and if he makes good, he may in turn hold the assignee.

A sublessee, on the other hand, is liable only to the lessor on the sublease. He is not liable on the major lease. But if the *tenant* (that is, the sublessor) defaults on the major lease, the landlord may oust the tenant and thereby sweep away the subtenant's rights, since they in turn depend for their existence on the rights of the tenant. As between the original landlord and the sublessee, there is no privity, no relationship of any kind. Neither, in law, knows the other.²⁴

1115. Attornment. Sometimes a tenant subleases premises and then surrenders his lease to the landlord. In such cases, if the subtenant continues in possession and pays rent directly to the original landlord, and the latter accepts the rent, the sublessee is said to *attorn* to the landlord; that is, he ceases to be a subtenant and becomes the direct tenant of the original landlord. In the absence of attornment, the sublessee need not recognize the original landlord at all, but is required to recognize only the original tenant as his landlord. If, in the absence of attornment, the original tenant fails to pay the original landlord his rent, the landlord may dispossess the tenant, and this would wipe out the subtenant's interest also even though the subtenant had paid *his* rent to the tenant.

1116. Liability to third parties for injuries. A tenant has exclusive possession. Hence he is liable to third parties for any

²⁴ For a case illustrating the foregoing distinctions, see *Johnson v. Mozley*, 216 Ala. 466, 113 So. 656.

dangerous or defective condition existing on the premises which may cause injury to such persons. However, if the premises were leased with a nuisance thereon, the landlord would be liable to third parties on account of the nuisance; and the tenant would also be liable if he discovered the nuisance and failed to remedy it within a reasonable time. A landlord is not liable for a nuisance unless it can be shown that he had knowledge of the condition which caused the injury, and failed to correct it within a reasonable time. Such defective condition may include defective coal hole covers, sidewalk gratings, areaways, cellar doors, and so on. A tenant is not liable when injury results from a condition of the premises not subject to his exclusive control, as in the case of common hallways, stairways, and so on. A landlord is not relieved from liability to third persons merely because the tenant is liable, too; but as between the landlord and the tenant, he may provide in the lease that if a judgment is recovered by third persons against the landlord for any negligent condition of the premises, the tenant shall bear the loss. This is what is meant by a covenant to "hold the landlord harmless."

1117. **Deposit of security.** In many jurisdictions, the courts declare that a landlord is liable as a *trustee* for security deposited with him by a tenant in connection with the lease. This means that a landlord must not commingle such funds with his own. More recently, this principle has been enacted into statute. For example, the New York Real Property Law provides that money so deposited by a tenant, until repaid or applied under the lease, shall constitute a trust fund in the landlord's possession. If the landlord sells the house, he must turn over the security to the buyer and duly notify the tenant of such fact; or he must return the deposit to the tenant; or he must retain the deposit and notify the tenant of such fact. A violation of these provisions constitutes a misdemeanor.

D. Leases

1118. **Nature and form.** As indicated in sections 1084-1085, a lease is a contract whereby, for a consideration called rent, one of the parties, the lessor, agrees to give possession of premises to the other, the lessee, upon certain terms, covenants and conditions.

Covenants v. conditions. A covenant is a promise or undertaking, usually under seal, that a person will do or refrain from doing some act.

Examples:

(1) A tenant's covenant to pay rent, or to use premises for a given purpose and no other, or not to assign or sublet.

(2) A landlord's covenant of quiet enjoyment (sec. 1096).

A condition is a circumstance on which the validity or continuance of a lease depends, which may or may not be supported by a promise or undertaking. The covenants above specified, for example, may also be conditions on which the validity or continuance of the lease depends. Since they are also covenants, nonperformance may give the injured party a remedy for damages in addition to terminating the lease. A mere condition, however, unaccompanied by a promise, provides no remedy for damages in case the condition fails.

Example: A lease of store premises fixing rent at a given percentage of gross receipts, with the stipulation that if such rent falls below a given figure, the lease will terminate.

Leases may be express or implied; and where express, they may be oral or written. However, in New York and a majority of the states, every lease for over a year must be in writing signed by the lessor or his agent duly authorized in writing.

1119. Rights of parties under void lease. We have already noted the distinction between a lease void when made, and a valid lease which becomes void afterwards (sec. 1086). Where the use of premises becomes illegal, the lease becomes void at the election of the tenant who, provided he surrenders possession, may plead constructive eviction (sec. 1099). No recovery for rent may be had on such lease after the tenant moves out and declares the lease void, except for the use and occupation of the premises during the period that the tenant was in possession, that is, the lease would be deemed valid for the purpose of recovering rent up to the time the tenant had declared it void.²⁵

²⁵ *Hizington v. Eldred Refining Co. of New York*, 235 App. Div. 486, 257 N.Y. Supp. 464; *Crommelin v. Thiess*, 31 Ala. 412; *Agar v. Winslow*, 123 Cal. 587, 56 P. 422; *Central Business College Co. v. Rutherford*, 47 Colo. 277, 107 P. 279; *Fleming v. King*, 100 Ga. 449, 28 S.E. 239; *Frepons v. Grostein*, 12 Idaho 671, 87 P. 1004; *Rubens v. Hill*, 213 Ill. 523, 72 N.E. 1127; *Talbott v. English*, 156 Ind. 299, 59 N.E. 857; *Leigh Banana Case Co. v. Rudy*, 147 Ky. 772, 145 S.W. 758; *Grabenhorst v. Nicodemus*, 42 Md. 236; *McCall v. New York L. Ins. Co.*, 201 Mass. 223, 87 N.E. 582; *Kuschinsky v. Flanigan*, 170 Mich. 245, 136 N.W. 362; *Jackson v. Eddy*, 12 Mo. 209; *Osmers v. Furey*, 32 Mont. 581, 81 P. 345; *Stewart v. Childs Co.*, 86 N.J. Law 648, 92 A. 392; *Poston v. Jones*, 37 N.C. 350; *Hoeveler v. Flemming*, 91 Pa. 322; *Edmison v. Lowry*, 3 S.D. 77, 52 N.W. 583; *Wade v. Herndl*, 127 Wis. 544, 107 N.W. 4.

1120. Standard provisions. Although most leases contain certain standard provisions, there are numerous variations making it foolhardy to sign a lease without careful reading. There are at least nineteen formal provisions usually found in a lease. These are discussed in section 1767. (Ten provisions of special importance to accountants are listed in section 1769.)

E. Termination of Tenancy

1121. Summary. A tenancy may be terminated in the following ways: (a) by expiration of lease, (b) by forfeiture, (c) by eviction, (d) by destruction of, or substantial injury to, premises, (e) by condemnation, (f) by surrender, and (g) by operation of law. The subjects of eviction, destruction of premises and condemnation have already been discussed in sections 1097-1102, 1109 and 1113 respectively.

1122. Expiration of lease: "holdovers." A tenancy for a fixed period ordinarily terminates upon the expiration of such period. If a tenant "holds over," the landlord may (a) treat the tenant as a trespasser, or (b) sue him for damages and remove him by legal proceedings, or (c) treat the tenant as obligated for an additional year. These remedies of a landlord do not exist when the tenant holds over because of sickness. Neither may a landlord exercise these remedies in the face of emergency rent laws (sec. 1094).

1123. Forfeiture. Forfeiture may result from the violation of some provision in the lease, such as nonpayment of rent.

Ejectment v. summary proceedings. Under the common law, when a person claimed a right to immediate possession of property occupied by another, he had but one legal remedy to oust the person in possession, namely, by a proceeding in *ejectment*. Such proceeding was and still is complicated and long drawn out. It requires, as a rule, the filing of a *lis pendens* (notice of pending action) and involves delay. *Summary* or prompt proceedings are now resorted to by a landlord in dispossessing a tenant. The proceedings are started by a *petition*, upon which a *precept* is issued, which requires the tenant to show cause, within a limited time, why he should not be dispossessed.

Forcible entry and detainer. No matter how just the landlord's claim against the tenant for possession of the premises, he must not resort to force, but must proceed according to law. If he resorts to force, he is guilty of a misdemeanor, and may further become liable in treble damages. The action brought by a tenant in such cases is known as an action for *forcible entry and detainer*.

1124. Surrender. Surrender is a mutual agreement between landlord and tenant, express or implied, to extinguish the tenancy, followed by repossession of the premises on the part of the landlord. Surrender may result from (a) agreement of the parties, or (b) operation of the law.

Surrender by agreement may be either express or implied. An express surrender results from the voluntary act of the parties, accompanied by an express agreement. An implied surrender may be based upon facts and circumstances from which an agreement to surrender may be inferred.

Surrender by operation of law results when both landlord and tenant take some action with respect to the premises which is inconsistent with the continuance of the term; for example, when the parties make a new lease, or when a tenant relinquishes possession and the landlord enters and occupies the premises for *himself*, or when a tenant returns the key to the landlord who accepts it without reservation.

1125. Termination of tenancy by operation of law. A tenancy may be terminated by operation of law, as in the case of death or bankruptcy.

Death of tenant. The death of a tenant automatically terminates a tenancy at will, but not a periodic tenancy, nor a tenancy for years (secs. 1090-1093), unless the lease so provides. Hence, when a tenant dies before the expiration of a lease for a fixed term, his estate is liable for the rent, which becomes a debt chargeable against estate assets.

Death of landlord. The death of a landlord has no effect upon a lease except to substitute a new landlord or landlords for the old. Ownership of premises carries with it the right to collect rent: If leased premises are sold, the tenant pays rent to the new owner. Similarly, upon death of a landlord, leased premises pass to new owners, namely, devisees under a will (sec. 1208) or heirs in case of intestacy (sec. 1176). These would be entitled to rent accruing after the landlord's death. Rent accrued and unpaid at the time of the landlord's death would go to the landlord's executor in case of a will, or administrator in case of intestacy, to be distributed in accordance with the will or the law governing intestacy, as the case may be.

Bankruptcy of landlord. (See sec. 1335.)

Bankruptcy of tenant. (See sec. 1335.)

1126. Duty of tenant upon vacating premises. If a tenant fails to remove his belongings within a reasonable time after vacating the premises, he is deemed to have abandoned them by the prevailing rule in a majority of states.²⁶ However, the landlord need not accept such abandonment but may require the tenant to remove his belongings. If the tenant fails to

²⁶ See section 1110, "Failure by tenant to remove fixtures," and section 1776.

remove them, the landlord may cause their removal at the tenant's expense,²⁷ since a tenant, in the absence of a contrary stipulation, must leave the premises as he found them, except for ordinary wear and tear. However, the tenant owes this duty only to the landlord, his heirs, or his transferees. He owes no such duty to new tenants or others between whom and the tenant no "privity of contract" exists (sec. 202).

Example: Shortly before a tenant's lease expired, the landlord contracted with the Demolition Company to wreck the building by a given date at a given price, less \$50 for each day's delay. The tenant, upon vacating, left a big safe on the premises, the removal of which cost the Demolition Company \$50 for a day's delay, for which sum the Company sues the tenant. Judgment would go to the tenant: He owed no duty to the Demolition Company.

Questions and Problems for Review

1. Define (a) landlord and tenant, (b) lease, (c) rent. *NY June 1923 (9)*

2. When is a lease of real property void? What is the responsibility of the owner if he leases it for unlawful purposes? *NY Jan. 1919 (6)*

3. Describe briefly *each* of the following tenancies: (a) for a specified term, (b) at will, (c) by sufferance, (d) periodical, such as from year to year. *NY Nov. 1934 (7)*

4. Give an illustration of each of the following: trade fixtures, ornamental fixtures. *NY May 1930 (5); NY May 1928 (5)*

5. A tenant puts machinery into a building for the purpose of running a mill. This machinery is put on solid foundations and attached to the property. The mortgagee of the landlord forecloses the mortgage and lays claim to the machinery as well. Is he entitled to it? State the principle involved. *NY Jan. 1916 (15)*

6. A tenant in the possession of a factory under a lease took out an engine, the property of the landlord, which was on the premises when hired and was included in the lease. The tenant located on the foundation a new engine for the purpose of carrying on his legitimate business, and stored the old engine, intending to replace it at the expiration of his lease. In whom does title in the new engine vest at the expiration of his lease? Is it a diminishing or a fixed asset of the tenant? Give reasons. *NY June 1921 (3)*

7. Emerson rented a furnished apartment containing a radio connected with receiving wires on the roof of the apartment house (with

²⁷ *Ide v. Finn*, 196 App. Div. 304, 187 N.Y. Supp. 202; *Lee Chuck v. Quan Wo Chong Co.*, 81 Cal. 222, 22 Pac. 594.

which radios in other apartments also were connected). Emerson removed this radio and substituted one of his own without injury to the connecting wires. At the termination of his lease he removed his own radio and reconnected the landlord's. The landlord claimed both radios. On what principle of law was this claim based? Should the landlord's contention be sustained? *AI Nov. 1934 (12)*

8. X leased a building from Y to be used as a jewelry store. Just prior to the expiration of the lease, Y contracted with Z to wreck the building. Z inspected the building prior to making his contract and in the contract he agreed to a legally enforceable penalty for delay beyond a specified date. Upon the expiration of the lease, X vacated, but he abandoned a large safe which he had placed in the basement of the building. The lease contained no provision applicable to either the installation or the removal of the safe. Z discovered the abandonment of the safe after X had vacated and notified X that he would hold X responsible for the cost of removing and disposing of the safe (which had no sale or scrap value) and also for any penalty for delay necessarily caused by the work of removing the safe. Could Z recover from X on either of these claims? *AI Nov. 1933 (9)*

CHAPTER XIII

Liens

1127. Scope of chapter. In this chapter we consider the nature and classification of liens, including common law, equitable and statutory liens; general and special (particular) liens; possessory and nonpossessory (charging) liens; and the various types of these liens met with in daily business practice.

A. Nature and Classification

1128. Nature of lien. A lien is a charge imposed on property by which the property is made security. It has been defined by the court as a "right to resort to property in order to enforce a debt or duty."¹ It may or may not be accompanied by actual possession of the property itself.

A lien is not to be confused with ownership. If one has a lien on certain property (for example, a mortgage) and then acquires title to the property, the lien merges into the ownership and ceases to exist. That is, one cannot have a lien on his own property.

The holder of a lien is known as a *lienor*.

1129. Lien *v.* pledge. Liens and pledges are alike in that they represent rights of a creditor in the property of a debtor by way of security. They differ, however, in two respects:

- (1) Liens do not always depend on the transfer of possession; pledges do.
- (2) In a pledge, possession is transferred for the purpose of security; in a lien, possession is not transferred for the purpose of security but for the hire of some service, and security is not the purpose of the transfer but only an incidental result, to secure payment for the services rendered. (See sec. 473.)

1130. Classification. Liens may be variously classified as follows:

- (a) As to legal origin: *common law*, *equitable* and *statutory* liens.
- (b) As to the debt or debts secured: *general* and *special (particular)*.
- (c) As to right of possession: *possessory* and *nonpossessory (charging)*.

¹ *Ancona v. Becker*, 14 Pa. Co. 73, 77.

We shall discuss liens in the order of this classification, including the rights, duties and liabilities of the parties concerned.

B. Common Law, Equitable and Statutory Liens

1131. Common law liens. A common law lien is the right, regardless of statute, to retain possession of personal property until some obligation in connection with it is paid or satisfied. Originally, common law liens were confined to the right which certain mechanics and artisans had to retain a chattel on which they had done some work at the owner's request. Gradually the common law right of lien spread to all cases involving personal property the possession of which is retained by one who has rendered some service in connection with it.

1132. Equitable liens. The so-called "equitable lien" is merely an application of equitable principles to a situation where the remedy at law is inadequate (sec. 8). The general characteristics of equitable liens are (a) absence of possession in the creditor, and (b) absence of an adequate remedy at law. Common law liens grew out of the fact that the creditor had possession of something belonging to the debtor, which he refused to return until some charge growing out of such possession (for example, repair work done on a chattel by an artisan) was paid or satisfied. (See sec. 1136.) If, in such case, the lienor surrendered possession, he lost his lien (sec. 1139). In the course of time, situations arose where, though possession was in the debtor, it was obviously inequitable to deprive a creditor of the right to have specific property applied to the payment of a debt. In such cases, equity imposed a "charging lien" upon the property (sec. 1143). In modern times, the doctrine of equitable liens has been liberally extended to facilitate mercantile transactions and to promote justice.

Examples:

- (1) Right of stoppage in transit (sec. 423).
- (2) Lien of one who lends money against an assignment of future cargoes.
- (3) Lien of a vendor of real property for the unpaid purchase price, when the price recited in the deed has not in fact been paid.

1133. Statutory liens. A statutory lien is one created by statute. Many statutory liens are merely "declaratory" of

pre-existing liens recognized at common law or in equity. Others represent new rights not previously recognized.

Example: Under the common law, the keeper of a livery stable was denied a lien. Such liens and their derivatives (see sec. 1238, "Motor vehicles, motor boats and aircraft") now exist by statute.

Most of the liens discussed in this chapter are statutory liens.

C. General and Special (Particular) Liens

1134. General liens. "A general lien is a right to retain a thing, not only for charges specifically arising out of or connected with that identical thing, but also for a general balance of accounts between the parties, in respect to other dealings of the like nature."² A general lien is not favored, and the law will refuse to recognize it unless the parties have clearly indicated an intention to create one.

Example: When securities are pledged to a banker or broker for the payment of a particular loan or debt, he has no lien upon such securities for a general balance or for the payment of other claims.

1135. Special or particular liens. A *special or particular* lien is a right to retain the property of another for some particular claim or charge upon the identical property retained. Such liens are favored in law. Examples of such liens are furnished in the case of any possessory lien (sec. 1136) on specific personal property for services rendered in connection with that particular property. (See sec. 1542, subd. (b).)

D. Possessory Liens

1136. Possessory lien defined. A possessory lien is the right to retain possession of another's property until some debt or charge in connection with it has been paid or satisfied. Possessory liens apply to personal property only. This is because personal property is movable and possession is on that account often essential to make the lien effective. This would not be true of real property.

1137. Essentials of possessory lien. A possessory lien is not valid unless possession is rightfully acquired and retained. If possession is wrongfully acquired, or if the person claiming a lien parts with possession and then wrongfully reacquires it, he does not thereby obtain a possessory lien.

² Story, *Agency*, sec. 354.

Example: Baron takes his car to the Barger Garage for repairs. The bill is \$38.50. Baron drives away, promising to pay the bill within a week. A week later Baron leaves the car at the garage to have a flat tire repaired. Barger refuses to surrender the car unless Baron pays the entire bill to date. Baron, upon tendering the cost of repairing the flat tire, may recover possession, because Barger, upon previously surrendering possession, lost his possessory lien for the original repairs and reacquired a particular possessory lien for the cost of the tire repair only. (Barger, of course, though he has lost his possessory lien, may sue Baron for the entire bill due him.)

1138. Types of possessory lien. There are numerous types of possessory liens. Most of these existed at common law and have been confirmed by statutory enactment. Generally speaking, every bailee for the hire of service has a possessory lien in connection with a bailment for mutual benefit (secs. 470-492). Possessory liens are of various types. Among the more common are the following:

Vendor's (seller's) lien. A vendor's lien is the right of a seller, even after parting with *title*, to retain *possession* of personal property until payment of the purchase price. (See sec. 422.)

Artisan's lien. One who has bestowed labor or services upon a chattel has a right to retain possession of it until he is paid for his work; as in the case of a watchmaker, machinist, garage mechanic, garment maker, silk manufacturer or shoemaker.

Agent's lien. (See sec. 560.)

Factor's lien on merchandise. The statute gives a consignee a lien on merchandise shipped to him for any advances made by him to the person in whose name the shipment is made. The statute is designed to protect factors who finance or help finance shipments of merchandise. The factor may reimburse himself for the amount of his lien by pledging or disposing of the merchandise for such purpose.

Common carrier's lien. A common carrier has a lien on goods shipped pending payment of transportation charges. The lien is a *special*, or *particular*, not a *general* lien; that is, it attaches to the goods involved in one transaction or one consignment for charges related to that transaction or connected with that consignment and does not extend to charges for other shipments under a separate contract.

Warehouseman's lien. (See sec. 486.)

Innkeeper's lien. (See sec. 487.)

Animal and livery stable keeper's lien. This lien, as previously noted (sec. 1228) is purely statutory; it did not exist under the common law. A person who keeps animals is known as an "agistor"; for example, one who boards horses, pastures cattle or maintains a dog and cat hospital. The keeper of a livery stable has a lien not only for animals kept, but also for any vehicles stored.

Motor vehicles, motor boats and aircraft. A person who keeps a garage, dockyard or hangar for the storage or repair of motor vehicles, motor boats or aircraft, or who furnishes gasoline or other supplies to the owners thereof, has a lien on such vehicles, boats or aircraft for any sum due for such storage, repairs or supplies. This lien exists even if the owner is only a conditional vendee or a mortgagor under a chattel mortgage (sec. 1161).

Examples:

(1) Parker buys an automobile under a conditional sale calling for a down payment of \$100 plus twelve additional installment payments, title to remain in the vendor until all installments are paid. The car is delivered to Parker against the down payment. Parker keeps his car at Grundy's garage. Several months' storage charges accumulate, also charges for repairs. The conditional vendor, not having received any further payments, seeks repossession of the car, but Grundy refuses to give it up until his charges are paid. The court will sustain Grundy's position, because his lien is superior to the claims of the conditional vendor.

Lien of truckmen and draymen. Every person, firm or corporation engaged in carting or trucking property has a lien on such property for services rendered.

Lien of motion picture film laboratories. Motion picture film laboratories have a lien for services rendered in storing, developing, copying, printing or otherwise rendering service in connection with motion picture film.

Lien of hospitals. A new type of lien created by statute, of which the New York statute is an illustration, is that which gives hospitals a lien on the proceeds of any lawsuit brought on behalf of an injured person receiving treatment in a hospital, in cases where the injuries are claimed to be the fault of some other person against whom suit is brought for the recovery of damages.

1139. Waiver of liens. As previously noted (sec. 1137), a possessory lienor who parts with possession loses his lien. He also waives his lien if he extends credit or accepts a note or check in payment. However, if he takes a note or check subject to collection, he does not waive his lien until the instrument is paid.

Examples:

(1) The Polar Fur Company sells a mink coat to a retailer for \$2000 and delivers a bill of sale against the retailer's thirty-day note. The company refuses to make delivery, however, until the note is paid, insisting that it has a seller's lien pending payment. The company's position is unsound: It waived its lien when it took the note.

(2) If the Polar Fur Company had taken the retailer's note, or a check, "subject to collection," it would not have waived its lien; delivery could have been lawfully withheld until the note or check was paid.

1140. Enforcement of possessory liens. The holder of a possessory lien in a chattel may satisfy his lien by a public sale of the chattel. The lienor must give notice of the sale to all persons having an interest in the chattel, and he must give the owner a time limit within which to discharge the lien by payment. If the lien is not discharged, the proposed sale is then duly advertised. The advertisement must describe the property to be sold and must state the name of the owner or person for whose account the property is to be sold and the time and place of sale. At any time before the property is sold, the owner may redeem it by paying the debt and expenses in connection with the lien. If the property is not redeemed and is sold, the lienor may retain from the proceeds of the sale an amount sufficient to satisfy his lien plus expenses. If there is a surplus, he must turn it over to the owner. If there is a deficit, the owner is personally liable for the difference.

1141. Other remedies of lienor. The lienor need not enforce his lien, but may bring an ordinary action for the recovery of the debt secured by the lien. If the lienor prefers, he may bring an action to foreclose the lien and procure a judgment thereon. Or he may resort to both remedies simultaneously, but in such event, he can have only one satisfaction.

Example: If *A* lends *B* \$7000 against stock of equal or greater value as collateral, and if, upon the debt becoming due and unpaid, the market value of the stock has declined to \$5000, *A* has three alternatives: (1) he may foreclose his lien and cause the stock to be sold, (2) he may sue on the indebtedness, or (3) he may do both. However, he may have but one satisfaction: If his debt has been satisfied, for example, the stock must be returned.

1142. No time limit on action to foreclose lien. There is no time limit on an action to foreclose a possessory lien or on the pledgee's right to sell, even though the debt secured by the lien may be barred by the statute of limitations.

Example: *A* deposits a gold watch with *B* to secure a \$100 loan and gives *B* the right to sell the watch if *A* fails to pay the loan when due. *A* defaults. Ten years pass. *B* may no longer sue on the debt, but he may foreclose the lien and sell the watch.³

³ *Conway v. Caswell*, 121 Ga. 254, 48 S.E. 956; *Pollock v. Smith*, 107 Ky. 509, 54 S.W. 740; *Farmers' Bank v. Iglehart* (Md.), 6 Gill 50; *Townsend v. Tyndale*, 165 Mass. 293, 43 N.E. 107; *Chouteau v. Allen*, 70 Mo. 290; *Hutson v. Title Guarantee and Trust Co.*, 118 Misc. 795, 799; *U.S. v. Mercantile Trust Co.*, 213 Pa. 411, 62 A. 1062; *Connecticut Mut. L. Ins. Co. v. Dunscomb*,

E. Nonpossessory (Charging) Liens

1143. Definition and nature. A nonpossessory or charging lien is one not dependent on possession. It usually attaches to real property, because such property is fixed and permanent and actual possession is not so essential to protect the lienor. Examples are (a) judgments, (b) mortgages, (c) mechanic's liens, and (d) tax liens. Instead of requiring possession as a condition for the lien, the statute provides for a means whereby the lienor may give public notice of the lien which he claims in respect to the property concerned. Such notice takes the form of a public record, which all may consult before buying the property affected or before lending money upon such property as security. Real property subject to such lien is said to be subject to "incumbrances." (See sec. 1784.)

Charging liens on personal property. Although charging liens usually concern real property, they may also affect personal property when possession is impractical and the filing of notice is sufficient to furnish some measure of protection. Examples of charging liens in connection with personal property are: (1) chattel mortgages (sec. 1161); (2) liens on vessels (sec. 1162); (3) liens on monuments, grave stones and cemetery structures, and for labor on stone (sec. 1163).

1144. Judgments. A judgment upon being "docketed" (filed) constitutes a lien against the debtor's real property. The period of the lien varies in the different states. A common period is ten years, with a right to renew for an additional ten years. Ordinarily, the docketing of a judgment creates no lien against the debtor's personal property, unless execution has been issued (sec. 73).⁴

1145. Mortgages: nature of. The word "mortgage," literally (from the French, *mort gage*), means "dead pledge." In the early days of the English common law, when a debtor pledged real property to secure a debt, he conveyed title and possession to the creditor, who collected rents, applied them to the debt, and became the absolute owner if the debt was not fully paid when due. The security thus became a dead pledge so far as the debtor was concerned. The hardships and inequities arising out of such transactions caused equity to intervene and to declare that the conveyance, though absolute in

108 Tenn. 724, 69 S.W. 345; *Goldfrank v. Young*, 64 Tex. 432; *Roots v. Mason City Salt Min. Co.*, 27 W.Va. 483.

⁴ *In re Flushing Queensboro Laundry*, 90 Fed. (2d) 601.

form, was really only a lien. Possession was retained by the debtor, but the creditor, upon default, instead of being allowed to declare a complete forfeiture, was permitted to bring a proceeding to shut out or "foreclose" all interests except his own, and upon obtaining judgment, to have the property sold to satisfy the debt; the surplus, if any, being turned over to the debtor.

Ordinarily, the word "mortgage," standing alone, means a real estate mortgage. Such a mortgage is defined as "the conveyance of an estate by way of pledge for the security of a debt, to become void on payment of it."⁵ The debt secured by the mortgage usually takes the form of a bond or note.

Real estate mortgage, purchase money mortgage and chattel mortgage distinguished. A real estate mortgage is a specific lien upon real property to secure the payment of an obligation. When the mortgage is given to secure an unpaid portion of the purchase price of property it is called a *purchase money mortgage* (sec. 1047). A *chattel mortgage* is a conditional transfer of title to *personal* property to secure the discharge of some obligation. Chattel mortgages are further discussed in section 1161.

Trust deed (trust indenture) v. mortgage. A trust deed, also variously known as a *deed of trust* and a *trust indenture*, resembles a mortgage in that both are given to secure an obligation, and both create a lien on the property concerned. A mortgage, however, is usually given directly by the debtor to the creditor in the form of a specific lien. A trust deed is given to a third party in the form of a conveyance, to be held by such third party as trustee for the creditor or creditors, the latter frequently constituting a group participating in the loan by the purchase of bonds in various denominations.

The instrument creating the trust lien is frequently referred to as the *trust indenture*. The parties to such instrument are the mortgagor (usually a corporation) and the trustee (usually a bank or trust company), which holds the instrument in trust for a third party or parties, usually bondholders secured by the terms of the trust indenture. Trust indentures commonly embrace, in addition to the customary mortgage clauses (sec. 1146) special provisions for the protection of the beneficiaries under the trust indenture, such as provisions for (1) a sinking fund ahead of any dividend declarations, (2) compliance with securities exchange laws and rules (in case the bonds are to be listed on any securities exchange), (3) conversion or retirement provisions, (4) acceleration of the full mortgage debt upon default in interest or other payments, (5) releasing the property from the lien of the indenture upon full payment, and (6) a specification as to the powers and duties of the trustee.

Parties to mortgage. The parties to a mortgage are the *mortgagor* who executes the mortgage to secure his obligation and the *mortgagee* to whom the mortgage is executed and delivered to secure the obligation due him.

⁵ Kent, *Commentaries*, p. 133.

1146. Contents of mortgage. The usual mortgage recites its date; name and address of the mortgagor and of the mortgagee; the principal amount of indebtedness secured, its due date, and the rate of interest payable thereon, according to the bond or other obligation secured; and a full description of the property mortgaged. In addition, the mortgagor usually covenants with the mortgagee as follows:

- (a) *Payment*: that the mortgagor will pay the indebtedness.
- (b) *Insurance*: that the mortgagor will keep the buildings on the premises insured against loss by fire for the mortgagee's benefit.
- (c) *Injury to premises*: that no building on the premises will be removed or demolished without the mortgagee's consent.
- (d) *Default clauses*: that the whole of the principal sum shall become due after default in the payment of any installment of principal when due, or of interest for thirty days, or after default in the payment of any tax, water rate or assessment for thirty days after notice and demand.
- (e) *Right to receiver*: that in case of foreclosure the mortgagee shall be entitled to the appointment of a receiver for the collection of rents, and so on.
- (f) *Taxes, assessments and water rates*: that the mortgagor will pay all taxes, assessments or water rates.
- (g) *Statement upon request*: that the mortgagor within six days upon request in person, or within thirty days upon request in writing, will furnish a statement of the amount due on the mortgage.
- (h) *Warranty of title*: that the mortgagor warrants title to the premises.

1147. Execution of mortgage. The formalities required for the execution of a mortgage differ in the different states. An indication of the usual requirements is suggested by the formalities required for the execution of a mortgage in New York, where a mortgage, whether made by an individual or a corporation, is executed in the same way as a deed (sec. 1050).

Execution of mortgage by corporation. A mortgage is executed by a corporation through one of its officers duly authorized by the board of directors; and the acknowledgment must recite this fact. A corporate mortgage is usually not valid unless accompanied by a certificate of the secretary evidencing that consent to the execution of such mortgage by the holders of two thirds of the total number of outstanding shares was duly obtained.

1148. Recording of mortgage. A careful mortgagee promptly records his mortgage for the same reason that a careful purchaser promptly records his deed (sec. 1051), namely, so that all persons who thereafter acquire any interest or claim in the property will do so subject to the recorded mortgage.

Example: If Smith, to secure a loan, gives me a mortgage on his house, and then, to secure a second loan from you, gives you another mortgage on the same house which you promptly record, my mortgage will be subject and subordinate to yours, unless you had either actual knowledge of my previous mortgage, by having been informed of it, or else "constructive" knowledge, by reason of the fact that my mortgage was on record when yours was created.

1149. Rights of mortgagor and mortgagee. A mortgage being a charging lien, the mortgagor continues in possession of the property as owner, notwithstanding the mortgage. The mortgagor's interest in the property, subject to the mortgage, is said to be his *equity*. The rights of the mortgagee are specifically fixed by the terms of the mortgage, including its covenants (sec. 1146). In the absence of specific terms, a mortgagee has the right to receive payment of principal and interest on his mortgage, to have the property stand intact as security, free from damage or diminution, and in case of default to have the property foreclosed and sold to pay the mortgage debt, with interest and court costs, and expenses of foreclosure.

1150. Assignment of mortgage. A mortgagee may assign his mortgage. In such event the assignee acquires only the interest of the assignor, and is subject to any claims or offsets which the mortgagor may have against the latter.

Estoppel certificate. An assignee should require the assignor to produce a certificate executed by the mortgagor wherein the latter acknowledges that he has no claims or offsets in connection with the mortgage. Otherwise the assignee takes the risk that such claims may be subsequently asserted by the mortgagor when the assignee requires payment of the mortgage.

1151. Taking "subject to" *v.* assuming mortgage. A person who buys real property with a mortgage on it takes either "subject to" the mortgage or agrees to assume it. In the former case, his maximum risk is that he may lose the property if the mortgage is foreclosed and sold. On the other hand, by assuming the mortgage, he becomes primarily liable on it as if he had executed the original bond and mortgage.

Deficiency judgment. When one is personally liable on a mortgage debt, and the property, on foreclosure, fails to fetch enough at the sale to satisfy the judgment, the mortgagee may enter a "deficiency judgment" and hold the debtor personally for the deficiency.

Example: Abel buys a house and lot for \$20,000, half of which he pays in cash and half by giving a purchase money bond and mortgage (secs. 1047 and 1145). He then sells the house to Baker, who takes the prop-

erty *subject to* the mortgage but does not assume it. Later the mortgage is foreclosed and the property sold for \$7500, leaving \$2500 still due. Abel is personally liable for this deficiency, but Baker is not. Had Baker assumed the mortgage, he would have been liable personally for the deficiency.

1152. Sale of mortgaged premises: respective liabilities of grantor and grantee. Upon the sale of mortgaged premises, the grantee takes the land subject to the condition that it is to stand as security for the mortgage debt. At least to the extent of the value of the land, the grantee stands in the position of principal debtor, with the grantor as surety, including the surety's right of subrogation (sec. 930), that is, his right, in case he pays the mortgage debt himself, to "stand in the shoes" of the mortgagee and to compel reimbursement from the grantee to the extent of the value of the land.

Example: In the preceding illustration, the fact that Abel sold the property to Baker was of no concern to the mortgagee: so far as he was concerned, Abel remained liable on the mortgage. If Baker defaulted on the mortgage, and Abel was compelled to pay it, Abel could compel reimbursement by Baker to the extent of the value of the land.

Liability when grantee assumes mortgage. When the grantee not only takes subject to the mortgage but assumes it, the mortgagee may hold either the grantee or the grantor for the full amount of the mortgage debt. He may hold the grantee under the Third Party Beneficiary Rule (sec. 200), because the promise was made to the grantor for the benefit of a third party (the mortgagee), and the grantor as promisee was obligated to such third party beneficiary. (See sec. 1792.) If the mortgagee prefers, however, he may hold the grantor, who is liable on the mortgage in the first place. If the grantor has to pay the debt, he in turn may hold the grantee, not only to the extent of the value of the property, but to the full extent of the debt, since the grantee assumed it.

1153. Extension of mortgage: effect of. The holder of a mortgage may extend its time of payment by executing and delivering an *extension of mortgage* to the mortgagor. When such agreement, upon sufficient consideration, is entered into between the mortgagee and the original mortgagor, the only effect is to postpone the time of payment.

Modification of mortgage without mortgagor's consent. Any modification of a mortgage, by agreement between the mortgagee and a subsequent owner without the mortgagor's consent, discharges the mortgagor. Thus, if the original mortgagor has sold the premises, and an extension agreement is entered into between the mortgagee and a subsequent grantee without the mortgagor's knowledge and consent, the latter, as surety, is discharged, at least to the extent of the value of the land as of the date of the

extension agreement; and if the subsequent grantee *assumes* the mortgage, the mortgagor will be discharged as to the entire mortgage debt. (For an example, see sec. 1791.)

Interest payments in advance, as modification of mortgage. Payment and acceptance of interest in advance, *after the mortgage debt is due*, constitutes an extension of the mortgage, and if this takes place without the mortgagor's consent, he is discharged. "A payment of interest in advance by a grantee and acceptance of the same by the mortgagee, where the principal amount has become due, amounts to an extension and will release the mortgagor, in the absence of an express reservation by the mortgagee at any time to return the surplus of interest or apply the same upon the principal and enforce payment of the balance."⁶

Example: Casey gave a mortgage on real estate. A subsequent grantee of the property personally assumed the mortgage. After the debt became due, the mortgagee accepted advance interest on the mortgage, without Casey's knowledge or consent. On foreclosure and sale, there was a deficiency, for which the mortgagee sought to hold Casey, who defended on the ground that the payment and acceptance of interest prior to its due date amounted to an extension of the mortgage without Casey's consent and thereby relieved him as surety. *Held*, for Casey.⁷

1154. Prepayment of mortgage; "prepayment clause." The mortgagee or person entitled to payment of the mortgage cannot be compelled to accept such payment before it falls due according to the terms of the mortgage, unless there is a clause in the mortgage which gives the mortgagor a right to prepay it. Such a clause, known as a "prepayment clause," may prove beneficial to the mortgagor or any subsequent purchaser if the current interest rate falls below the rate fixed in the mortgage.

Example: Cole owns an office building on which Davis holds a \$100,000 mortgage at 5% interest. The mortgage has five years more to run. Cole can raise a new mortgage on the building for \$100,000 at 4%, or a saving in interest of \$1000 a year. If the mortgage held by Davis has a prepayment clause, Cole can pay it off with the new mortgage loan, otherwise not, unless Davis consents to the prepayment.

Accelerating payment. Mortgages commonly provide that the entire principal sum shall become due after default in the payment of any installment of principal or interest, or of any tax, water rate or assessment, for a given number of days (usually thirty days or less). Such a provision is for the benefit of the mortgagee, and only the mortgagee may take advantage of it. Thus, a mortgagor cannot compel the mortgagee to accept prepayment by deliberately defaulting in the payment of interest. (See sec. 1788.)

⁶41 *Corpus Juris* 736.

⁷*Germania Life Ins. Co. v. Casey*, 98 App. Div. 88, 90 N.Y. Supp. 418, *aff'd* 184 N.Y. 554.

1155. Satisfaction of mortgage. A mortgage is "satisfied" by payment. A mortgage should not be paid without receiving a sworn certificate by the mortgagee certifying to the fact that the mortgage has been paid. Such certificate is known as a *satisfaction piece*. The satisfaction piece should be promptly recorded, so that the record will show that the property is free and clear of the mortgage.

1156. Foreclosure of mortgage. To "foreclose" is to shut out. When a mortgagee forecloses a mortgage he seeks a judicial decree and judgment shutting out all interests except his own in connection with the mortgaged property. A suit in foreclosure is brought in a court of equity. If successful, it results in a *judgment of foreclosure*. Usually a referee or master is appointed by the court to compute the amount due. The judgment directs that the property be sold at a *foreclosure sale* conducted by an auctioneer under the direction of such referee or master. If the property sells for more than the amount of the mortgage, plus interest, costs, fees and expenses, the surplus, representing the owner's "equity" (sec. 1149), is turned over to him. If the property sells for less than the amount due, a *deficiency judgment* is entered and the mortgagor may be required to make good the deficiency.

1157. Equity of redemption. Originally, the owner's *equity of redemption* meant the right in equity, upon paying the debt, to redeem property which the owner had deeded to his creditor. In the course of time, as noted (sec. 1145), equity came to regard such transactions as liens rather than conditional conveyances. The owner was allowed to remain in possession, but the mortgagee was given a right to foreclose and sell the property upon the owner's default. To balance the remedy of foreclosure, equity gives the mortgagor the right, within certain limits, to redeem his property from a forced sale under foreclosure. Such right is now known as the mortgagor's *equity of redemption*. It may be exercised either before judgment of foreclosure, or after judgment and before sale, but not, as a rule, after conveyance upon the foreclosure sale. Only the owner, or some person claiming under him by assignment or sale, may exercise the equity of redemption.

1158. Marshaling assets among several mortgagees. We have already referred to the principle of marshaling assets, both as an equitable doctrine generally (sec. 10) and in distrib-

uting assets among creditors upon a partnership dissolution (sec. 708). The doctrine of marshaling assets is frequently applied in apportioning rights among several mortgagees. If one creditor holds two separate liens on two separate parcels to secure a single debt, each ample to satisfy the debt, and another creditor holds but one lien on one of the parcels, the first creditor, in case of default, should foreclose on the property not covered by the second creditor's lien, otherwise he unnecessarily wipes out the second creditor's lien. In the latter event, the law might subrogate (sec. 930) the second creditor to the first creditor's lien on the other parcel.

Example: Monroe owns two parcels, one worth \$75,000, the other \$50,000. He borrows \$30,000 from Green and gives Green a \$30,000 mortgage covering both parcels. Then he borrows \$10,000 from Nelson on a second mortgage covering the \$50,000 parcel. He defaults on the first debt. By the rule of marshaling assets, Green should foreclose on the \$75,000 parcel, because in so doing, he will obtain satisfaction without injuring Nelson. Should Green foreclose on the \$50,000 parcel and wipe out Nelson's mortgage, Nelson will be subrogated to Green's mortgage on the \$75,000 parcel.

1159. Mechanic's lien. A *mechanic's* lien should not be confused with an *artisan's* lien. A mechanic's lien is the charging lien of a contractor, subcontractor, laborer or material man who performs labor or furnishes materials for the *permanent* improvement of *real property*, with the consent or at the request of the owner, or of his agent, contractor or subcontractor. A mechanic's lienor has a lien for the principal and interest of the value or agreed price of the labor or materials furnished from the time he files a notice of such lien in the public filing place prescribed by statute. If a mechanic's lien is not discharged or satisfied, it may be foreclosed, subject to any other prior liens. The mechanic's lienor is paid out of the proceeds of such sale, the surplus being turned over to the owner of the property.

Contractor's lien on insurance moneys. A building contractor or subcontractor has a lien on the proceeds of insurance received by the owner of premises destroyed or removed by fire or casualty, to the extent of such contractor's lien. Material men and working men are likewise protected as to any insurance moneys received by a contractor or subcontractor.

1160. Tax liens. A tax lien may be imposed by statute in favor of a governmental authority, Federal, state or local, for the purpose of securing the payment of taxes. Tax liens may

be imposed upon either real or personal property; but it is customary for real property taxes to attach only to the real property taxed. If the tax is not paid, the lien may be foreclosed, and upon the subsequent tax sale a purchaser may acquire a valid title if the proceedings have been regular in every respect. Such title is known as a *tax title*.

1161. Chattel mortgages. A chattel mortgage takes the form of a conditional transfer of title. In this respect it resembles, at least in form, a real estate mortgage transaction as it originally existed under the common law, when the borrower simply gave a deed as security for the debt. Under a chattel mortgage the borrower (chattel mortgagor) gives the lender (chattel mortgagee) title to personal property as security for the debt.

Chattel mortgage v. conditional sale. Chattel mortgages, like conditional sales, are in common use in connection with instalment sales (sec. 439). In a conditional sale, as we have already noted (secs. 439-440), title does not pass immediately but only upon the *condition precedent* (sec. 217) of prior compliance with the conditions of the instrument (that is, upon payment of all the instalments). In a chattel mortgage, on the other hand, the seller passes title to the buyer who then technically passes it back to the seller in the form of the chattel mortgage. Such retransfer takes effect immediately, but it is subject to the *condition subsequent* (sec. 217) that the chattel mortgage shall become void and that title shall automatically vest in the buyer if the conditions of the chattel mortgage are fully met.

Chattel mortgage v. pledge. A chattel mortgage, as noted in section 472, differs from a pledge in at least three respects.

Filing of chattel mortgage. As pointed out in section 472, a chattel mortgage, unlike a pledge, does not in and of itself constitute notice of the creditor's rights in the chattel. Hence the creditor, if he wishes to protect his rights, must give public notice of his lien on the chattel. This he does by filing the chattel mortgage or a true copy of it in a prescribed public place. Failure to do this may give an innocent purchaser a prior right as against the chattel mortgagee, though the debtor himself remains liable.

Example: Morse sold Larkin an electric refrigerator for \$300, against a chattel mortgage providing for twelve monthly payments of \$25 each. Larkin made a down payment of \$25, and ten days later sold the refrigerator for \$200 to Griffin, who assumed that Larkin was the true owner. Larkin then disappeared. If, prior to the sale to Griffin, Morse had filed his chattel mortgage, he could reclaim the refrigerator, otherwise not.

Refiling of chattel mortgage. The filing of a chattel mortgage, in most states, is effective for one year only. If the mortgage remains unsatisfied at the end of a year, it should be refiled.

Filing v. recording. To *file* a document in a public office is to place it in official custody. To *record* a document is to copy it off into a public book or "liber." The usual statutory provisions for constructive notice relating to chattel mortgages and conditional bills of sale require that they be *filed*, not recorded. On the other hand, statutes in respect to deeds and real estate mortgages require that such instruments be *recorded*.

Fraudulent chattel mortgages. Similar to the provisions of the *Bulk Sales Act* (sec. 431) is the statutory provision, now common,⁸ that a chattel mortgage on goods in bulk or on merchandise and fixtures pertaining to the conduct of the mortgagor's business is void unless the following steps are taken: (1) The mortgagor, at least five days before executing the mortgage, must make up a full inventory showing each article included in the mortgage and its cost price. (2) The mortgagee must demand and receive from the mortgagor a sworn list of names and addresses of the mortgagor's creditors, specifying the amount due each creditor. (3) The mortgagee, at least five days before the mortgage is executed, must notify every creditor personally or by registered mail of the proposed mortgage and its terms.

1162. Liens on vessels. Although vessels constitute personal property, they are by their very nature not readily subject to possessory liens. The law creates a lien against vessels in favor of any person rendering labor or material in building, repairing, fitting, furnishing or equipping a vessel; also for any provisions and stores furnished to the vessel, wharfage, services in loading and unloading, towing, piloting, insurance and even damage caused by the negligence or wilful misconduct of the person navigating the vessel. The statute usually requires that a notice of the lien be filed in the county clerk's or similar public office. Maritime liens, though prescribed by both state statute and act of Congress, have been recognized under the common law for many years.

1163. Miscellaneous charging liens. In addition to the charging liens already specified, the law provides for other charging liens in respect to personal property in cases where a possessory lien would be impractical or contrary to public policy. Examples are liens on monuments, gravestones and cemetery structures, and liens for labor on stone.

Questions and Problems for Review

1. What are the general characteristics of equitable liens? *NY Oct. 1933 (4)*

⁸ An example is the New York Lien Law, sec. 230-a.

2. State differences, if any, between a "particular lien" and a "general lien." *NY May 1929 (2)*

3. A bank loaned *X* \$10,000. *X*, needing further assistance, borrowed an additional amount of \$20,000 of the bank for the payment of which he pledged 500 shares of stock. Later *X* became insolvent and a trustee was appointed to administer his estate. The bank sold the 500 shares of stock for \$25,000, paid the loan of \$20,000 and applied the surplus of \$5000 on the prior indebtedness. The trustee sued the bank for the \$5000. Will the trustee succeed? Explain. *NY June 1916 (13)*

4. Distinguish between a possessory lien and a charging lien. Give an illustration of each. *NY May 1926 (10)*

5. What kind of lien has each of the following lawfully in possession in the usual course of the employment: (a) common carrier, (b) special agent, (c) warehouseman, (d) shoemaker? *NY Nov. 1926 (6)*

6. *A* loans *B* \$7000 accepting as collateral security for the debt, certain stock. The debt becomes due and is unpaid, the market value of the collateral at the time being \$5000. State *A*'s remedies for recovery of the loan. *NY Jan. 1918 (7)*

7. *A* deposits a gold watch with *B* to secure a loan of \$100 and gives *B* the right to sell the watch at public or private sale in case of *A*'s default in the payment of the loan. At the end of ten years *B* sues *A* for the loan, and *A* defends on the ground that the debt is outlawed by the statute of limitations. What is *B*'s remedy? *NY June 1916 (14)*

8. Name three classes of liens on realty and describe one of the classes you have mentioned. *NY Nov. 1929 (7)*

9. State how a real estate mortgage should be executed by (a) an individual, (b) a corporation, and state why it should be recorded. *NY June 1918 (9)*

10. O'Rourke gave a mortgage on real estate to Kenyon. The mortgage note was not paid at maturity but interest was paid currently, and the mortgage continued in force as an open one without formal renewal. The property was conveyed several times until it reached Wulff. Wulff as owner made an agreement with Kenyon as mortgagee, personally assuming the mortgage debt, extending the time for the payment of it and specifying that interest was to be paid on February 19 and on August 19 of each year. Wulff then conveyed the property to Coleman, who paid the interest for several years, each payment being made from one to five days before it was due. The mortgagee upon foreclosure sought to hold Wulff for a deficiency. Wulff defended on the ground that the payment and acceptance of interest prior to its due date amounted in each instance to an extension of the mortgage without his consent and

thereby relieved him as surety. Is his defense legally sound? *AI Nov. 1933 (2)*

11. Who may redeem real property from a forced sale and within what period of time? *NY Jan. 1919 (13)*

12. Who are the parties to, what is the purpose of, and what are some of the provisions of, a trust indenture in a bond issue? *AI May 1931 (5)*

13. Monroe was the owner of two parcels of real estate, one known as 617 Grand Ave. and the other as 1014 Superior Ave. The former was worth \$75,000 and the latter was worth \$50,000. On January 4, 1929, Monroe borrowed \$30,000 from Green on a three-year note secured by a first mortgage on both parcels. On January 11, 1929, Monroe borrowed \$10,000 from Nelson on a three-year note secured by a second mortgage on the Superior Ave. property. Upon Monroe's default upon the payment of his note, Green foreclosed his mortgage on the Superior Ave. property and realized \$30,000 from the foreclosure sale. Upon the maturity of Nelson's note, Monroe failed to pay it.

(a) Has Nelson any rights except to procure a judgment against Monroe?

(b) If Nelson has any such right, upon what principles of law is it based? *AI May 1932 (10)*

14. What is a chattel mortgage? Must a chattel mortgage be recorded? Give reason for your answer. *NY Nov. 1930 (3)*

15. (a) What steps must be taken to make a chattel mortgage valid against other creditors of the mortgagor? (b) After what lapse of time does a chattel mortgage become invalid and what steps are necessary to keep it alive? *NY May 1925 (10)*

CHAPTER XIV

Wills, Inheritance and Estate Administration

1164. **Scope of chapter.** In this chapter we consider the rights of persons to direct the disposition of their property upon their death, including a discussion of the persons who may make a last will and testament, the property which may be transferred, the persons to whom it may be transferred, and the limitations imposed by law upon the right to make such transfers; how a will must be executed and how it may be revoked; the different kinds of wills; how a will is proved, construed and put into effect; the laws of inheritance which govern the administration and disposition of a person's property when he dies without leaving a will; the rules of law governing the appointment and qualification of executors and administrators; and the general principles of estate administration (except in respect to trust estates, which are considered in the next chapter).

A. Decedent Estates Generally

1165. **Status of property upon a person's death.** When a person dies, some disposition must be made of his property. Such person is known in law as a *decedent*. If he has left a will, he is said to have died *testate*; and if such will is valid, the decedent's property is disposed of in accordance with the will. If the decedent leaves no will, he is said to have died *intestate*, and he is sometimes referred to as *the intestate*. In such cases the law steps in and directs the disposition of his property.

1166. **Decedent estates: courts.** The branch of law which governs the distribution and administration of a decedent's estate is known as the *law of decedent estates*. It is also spoken of as *probate law*. It includes not only all legal questions relating to the orderly administration and distribution

of decedent estates, but also the relationship of guardian and ward, and the care and custody of the estates of lunatics, idiots, feeble-minded persons and others under natural disabilities. Probate law is largely statutory. It is administered in special courts having exclusive jurisdiction over decedent estates. These courts are variously known as "surrogate's courts," "probate courts," and "orphans' courts." In some states, probate matters are within the jurisdiction of the county courts.

B. Wills

1167. Will defined: testator. A will is a disposition of property, real or personal, to take effect upon the death of the person who makes it, who is known as a *testator*.

Outright distribution v. deferred distribution: trusts. Most wills provide for an outright distribution after payment of debts and expenses. Such wills designate an *executor* to make the distribution. However, persons who accumulate wealth are prone to direct that it be kept intact as long as possible. Often they wish to defer distribution of principal for someone's lifetime, or until certain next of kin mature, or for other reasons. In such cases, they establish trusts, with provision for a trustee to succeed the executor and to administer the trust fund until such time as the will directs final distribution. (The subject of *trusts* is discussed in the next chapter.)

1168. Who may make will. The New York rule specifying who may make a will is substantially the same as that throughout the country: All persons except idiots, persons of unsound mind and infants may dispose of real property by will; and every person of the age of eighteen years and upwards, of sound mind and memory, and no others, may dispose of personal property by will. The age limitation applies to the testator's age at the time of making the will, not at the time of death. Hence, if one makes a will while he is an infant nineteen years of age, disposing of real and personal property, and then dies at the age of twenty-three, the will is valid as to the personalty but not as to the realty.

1169. Freedom of transfer by will: restraints. Ordinarily, a person may freely transfer any of his property to any person or persons selected by him. To this rule, however, there are certain exceptions. These involve (a) rights of a surviving spouse, (b) after-born children, (c) charitable bequests, (d) witnesses to a will, (e) confidential data, and (f) the rule against perpetuities.

(a) *Rights of surviving spouse.* In the states which still observe the common law rule, a testator's right to dispose of his property by will is subject to dower but not to curtesy (sec. 1042). Many states have abolished the common law rights of dower and curtesy, and have substituted, in their place, the absolute right of a surviving spouse, as an heir, to take a fixed percentage of the estate, real and personal. In New York, for example, a surviving spouse cannot be disinherited, nor compelled to take the amount left by will if it is less than the amount prescribed by statute.

(b) *After-born children.* When a person makes a will and makes no mention of, or provision for after-born children, a child born to the testator after the making of the will is entitled to receive the same share that he or she would have received had the parent died intestate (sec. 1260). This includes after-adopted children, who, for the purpose of this rule, are treated as born at the date of adoption. The law presumes that a parent intends to provide for his children by will. If, however, a parent having a child makes a will without providing for such child, the law will not presume that the parent forgot his child; the child will be deemed cut off by the will.

(c) *Charitable bequests.* No person may leave more than half of his net estate to charity if he leaves a surviving spouse, child or other descendant, or parent.

(d) *Witnesses to will.* When a witness is named as a beneficiary under a will, and the will cannot be proved without his testimony, he will not be allowed to take under the will. Neither can he refuse to testify for the sake of protecting his interest. However, if the witness is to share in the estate whether the will be proved or not, he will take either by will, or by intestacy, whichever will give him the *lesser* amount.

Example: The testator's brother is a necessary witness to a will which gives him \$10,000. If there were no will, he would receive \$5000. He may be compelled to testify to the will, but is entitled only to \$5000. If, by intestacy, he would be entitled to \$15,000, he would have to testify, but would receive only \$10,000.

(e) *Confidential data.* Although a person who acquires confidential data in a professional capacity is entitled to the physical records or working papers as part of his files, he may not bequeath such data. If he does, the executor should return it to the client, or if that cannot be done, he should destroy it.

Example: If an accountant bequeaths his office files and records, the legatee is not entitled to data affecting clients confidentially, but such records should be returned to the clients if possible, otherwise destroyed.¹

(f) *Rule against perpetuities.* The law places a limitation upon the maximum period for which a person may tie up his estate and control its disposition by will. (See sec. 1229.)

1170. Formal requisites of will. Generally speaking, any writing to take effect at death may constitute a will. How-

¹ *Estate of William H. Dennis*, New York Law Journal, Feb. 15, 1936, page 827.

ever, statutes vary as to the formal requisites of such a writing. Some states merely require a simple statement of the testator's wishes, duly signed by the testator. Others require certain additional formalities, in the absence of which the will cannot be proved. For example, in New York, the following formalities must be observed or the will is invalid: (a) the will must be signed by the testator at the end; (b) the testator must sign in the presence of the attesting witnesses or he must acknowledge his signature to each of the attesting witnesses; (c) at the time of affixing or acknowledging his signature, the testator must declare the instrument to be his last will and testament; and (d) there must be at least two witnesses, each of whom must sign his name at the testator's request. Although most states require two witnesses, some require three, and three are advisable, since one or more of the witnesses may predecease the testator, or be difficult to locate.

Extraneous papers and documents: incorporation by reference. Ordinarily, the law refuses to recognize any disposition of property to take effect on death, unless it complies with the formal requisites of a will. However, with the exception of one or two states, the law permits a person to refer in a will to an extraneous paper or document and thereby to make it part of the will, provided the following conditions are present:

(1) The document must be in existence at the time the will is executed, and must be referred to in the will as an existing document.

(2) It must be clearly identifiable and identified as the paper referred to in the will.²

Example: Unsigned memoranda may not be incorporated into a will by reference.³

(3) The reference must show a clear intention by the testator to incorporate or adopt the document as part of the will.

(4) The document must be purely factual, and must not in itself direct a disposition.

² *In re Willey's Estate*, 128 Cal. 1, 60 P. 471; *Keeler v. Merchants' Loan & Trust Co.*, 253 Ill. 528, 97 N.E. 1061; *Fickle v. Snepp*, 97 Ind. 289; *In re Cameron's Estate* (Iowa), 241 N.W. 458; *Derr v. Derr*, 123 Kan. 681, 256 P. 800; *Traughber v. King*, 235 Ky. 658, 32 S.W. 2d 8; *Hall v. Hill, McLean & Co.*, 6 La. Ann. 745; *Ex parte Hull*, 164 Md. 39, 163 A. 819; *Bemis v. Fletcher*, 251 Mass. 178, 146 N.E. 277; *Jennings v. Reeson*, 200 Mich. 559, 166 N.W. 931; *Ray v. Walker*, 293 Mo. 447, 240 S.W. 187; *In re Hopper's Estate*, 90 Neb. 622, 134 N.W. 237; *Watson v. Hinson*, 162 N.C. 72, 77 S.E. 1089; *In re Neil's Estate*, 111 Or. 282, 226 P. 439; *In re McClure's Estate*, 309 Pa. 370, 165 A. 24; *Merrill v. Boal*, 47 R.I. 274, 132 A. 721; *Richardson v. Byrd*, 166 S.C. 251, 164 S.E. 643; *Grubb v. Anderson* (Tex. Civ. App.), 38 S.W. 2d 847; *Pollock v. Glassell*, 2 Gratt. (43 Va.) 439.

³ *In re Rand's Will*, 120 Misc. 670, 200 N.Y. Supp. 334, 336.

Examples (effective):

- (1) Reference to a schedule of securities.
- (2) Reference to a list of names.

Examples (ineffective):

- (1) Reference to certain directions to pay certain checks to be drawn by the executor.
- (2) Reference to a letter from the testator to a beneficiary setting forth how certain securities are to be handled.
- (3) Reference to a trust instrument.

Codicils. A codicil is a testamentary disposition subsequent to a will, by which the will is altered, explained, added to, subtracted from, or confirmed by way of republication, but in no case totally revoked.⁴ The term *will* includes all codicils. A codicil must be executed with the same formalities as those applying to wills.

Witnesses to will: statutory penalties. Witnesses to a will need not know its contents. Difficulties in locating witnesses for probate have led to statutes making it mandatory for witnesses to add their addresses to their signatures. Thus, in New York, if a witness fails to add his address to his signature, he may be compelled to forfeit \$50 to any person concerned in the will.

Attestation clause. In addition to witnesses' signatures, it is customary for a will to contain an "attestation clause," reciting that the will was signed, published and declared by the testator as and for his last will and testament, and that the witnesses thereupon, at the testator's request, and in his presence, and in the presence of one other, subscribed their names as attesting witnesses and their respective places of residence. Such clause is not always essential to the validity of a will, but it has weight in showing proper execution.⁵

Date: Sundays and legal holidays. A will should be dated, for practical reasons, but a date is not essential to its validity. A will or codicil may be executed any day, including Sundays and legal holidays.

1171. Holographic wills. A holographic will is one entirely in the handwriting of the testator. Although there is a strong presumption favoring the validity of holographic wills, such

⁴ *Black's L. Dic.*, 212.

⁵ *Woodruff v. Hundley*, 127 Ala. 640, 29 So. 98; *Wehrkamp v. Burnett*, 82 Colo. 5, 256 P. 630; *Deupree v. Deupree*, 45 Ga. 415; *Cunningham v. Hallyburton*, 342 Ill. 442, 174 N.E. 550; *Barricklow v. Stewart*, 163 Ind. 438, 72 N.E. 128; *In re Bybee's Estate*, 179 Iowa 1089, 160 N.W. 900; *Osborn v. Cook* (Mass.), 11 Cush. 532; *In re Thomas' Estate*, 243 Mich. 566, 220 N.W. 764; *Fatheree v. Lawrence*, 33 Miss. 585; *German Evangelica Bethel Church of Concordia v. Reith*, 327 Mo. 1098, 39 S.W. 2d 1057; *In re Diener's Estate*, 79 Neb. 569, 113 N.W. 149; *In re Wallace's Will*, 148 Misc. 867, 265 N.Y. Supp. 898; *Allaire v. Allaire*, 37 N.J. Law 312, affirmed 39 N.J. Law 113; *Ward v. Logan County*, 12 Okl. 267, 70 P. 378; *Maynard v. Jacobs*, 49 R.I. 224, 141 A. 616; *Pollock v. Glassell*, 2 Gratt. (43 Va.) 439; *Enright v. Griffith*, 165 Wis. 601, 163 N.W. 138.

wills must nevertheless be executed, as a rule, with the same formalities as those governing ordinary wills. In many states,⁶ however, the formalities of attestation and subscription by witnesses are unnecessary to the validity of holographic wills.

1172. Nuncupative wills. A nuncupative will is an oral will. It is invalid unless made by a soldier or sailor in actual military service or a mariner at sea. There must be at least two witnesses to prove a nuncupative will. In many states, a nuncupative will can dispose of personal property only. In some states (New York, for example), the statute provides that a nuncupative will becomes invalid a year after discharge from the military or naval service, unless the testator lacks testamentary capacity at such time, in which event it becomes invalid a year after he regains testamentary capacity.

1173. Revocation of will. A will may be revoked by act of the testator, as by making a subsequent will, or by destruction, cancellation, and so on; or by operation of law, as by marriage or divorce.

(a) *Revocation by subsequent will.* A will is effective only if it is the testator's last will and testament. Hence if a person makes a will, and then makes a later one, the former will is automatically revoked by the latter.

(b) *Revocation by destruction, mutilation, cancellation or obliteration,* provided the same is deliberate and intentional, revokes the will. If one accidentally tears up a will or throws it into a fire, or spills a bottle of ink on it, no revocation is shown, and the will may be established if it can be proved by proper evidence.

(c) *Marriage.* At common law, an unmarried woman's will was revoked by subsequent marriage, but not an unmarried man's. This rule has been modified by statute. Generally, regardless of sex, if a testator marries after making a will, and then dies, the will is deemed revoked as to the surviving spouse, unless provision for the latter has been made by an "antenuptial" or a premarital agreement in writing. If no such provision has been made, the surviving spouse may take as if the testator had died intestate.

(d) *Divorce.* In the absence of a statute to the contrary, divorce alone does not revoke a testator's will. Divorce accompanied by a property settlement has been held to spell out an implied revocation.

1174. Probate of will. To probate a will is to prove it. Proceedings for the probate of a will are instituted by a peti-

⁶Including Arizona, California, Idaho, Kentucky, North Carolina, Oklahoma, Pennsylvania, Texas and Virginia, as well as the District of Columbia. In New York, attestation of a holographic will is dispensed with only when made by a soldier or sailor in actual service or a mariner at sea.

tion. Generally, a petition to probate a will may be presented by any person designated in the will as executor, devisee, legatee, testamentary trustee or guardian, or by the general guardian of an infant devisee or legatee, or by a creditor of the decedent, or by any party to an action involving the estate. Before the will can be admitted to probate, proof must be given, through the attesting witnesses, that the will was duly executed, that the testator when he executed it was in all respects competent to make a will, and that he was under no restraint when making the will.

1175. Construction of will. The parties interested in a will may request the appropriate court (sec. 1166) to construe the meaning of doubtful clauses in a will. Often a court must construe a will in litigation concerning it. In construing a will, the court seeks to give effect to the true intention of the testator so far as it can be gathered from the contents of the will and the surrounding circumstances.

C. Inheritance: Descent and Distribution

1176. Inheritance: heirs. The term *inheritance* has nothing to do with a will. It relates to the rules of law by which the real property of an intestate (sec. 1165) passes to his heirs. The term *heirs*, under the common law, designates all those persons who by law are entitled to a fee interest (sec. 1027) in the real property of an intestate. Under the early common law, this meant the decedent's eldest son, in accordance with the rule of *primogeniture* (descent to the eldest son). Originally, a decedent had no right to violate this rule of inheritance by even attempting to dispose of his real property by will. Today, the distinction between real and personal property, for purposes of intestate succession, has been abolished in many states.

1177. Personal representatives and next of kin. The term *personal representatives* generally means executors and administrators. However, under the common law, the term was employed to designate all those entitled to share in the unbequeathed *personalty* of a decedent, as distinguished from his *realty*. Thus, a surviving spouse, being entitled to share in the decedent's unbequeathed personalty, was a "personal representative"; but not being entitled to a fee interest in the realty, but only to a life interest, such as dower or curtesy

(sec. 1042), the surviving spouse could not be an "heir." Neither could a surviving spouse be classed as "next of kin," because "next of kin" involved kinship, and included all those who were related by blood to the decedent; for example, children, parents, brothers, sisters, and so on. Thus, under the common law, a decedent's personal representatives include a surviving spouse *plus* next of kin. New York and many other states have abolished the distinction between heirs and personal representatives. In such states, a surviving spouse takes an outright share of the decedent's property, regardless of whether it is real or personal.

1178. Procedure on intestacy. When a person dies intestate, it becomes necessary to apply to the court for authority to administer his estate. Such application takes the form of a petition for *letters of administration* (sec. 1187), upon the issuance of which the administrator takes possession of, administers and distributes the estate.

Property in different states: law applicable. When the intestate leaves real and personal property in several states, the real property passes in accordance with the law of the state where it is situated (*lex situs*), and the personal property is distributed in accordance with the law of the decedent's domicile.

1179. Order of intestate succession. The order of intestate succession varies in the different states. Some states, in distributing intestate property, still preserve the distinction between real property and personal property, giving the former to heirs (sec. 1176), and the latter to personal representatives (sec. 1177). In other states, as noted (sec. 1177), the distinction between real and personal property has been abolished. The prevailing rule of priority governing intestate succession (except for a surviving spouse) has been summarized as Down, Up and Across; that is:

First, down to *descendants*, including children, grandchildren, great grandchildren, and so on, and if none such survive, then,

Second, up to *ascendants*, including parents, grandparents, great grandparents, and so on, and if none such survive, then,

Third, across to *collaterals*, that is, brothers and sisters, or their children (nephews and nieces), or brothers and sisters of parents (that is, uncles and aunts), or their children (that is, cousins).

In New York and other states, the rule of descent and distribution, upon the death of a person intestate, are substantially as follows:

(1) *Decedent leaves spouse and children, or grandchildren by a deceased child or children*: one third to surviving spouse; residue in equal portions to the children or grandchildren, *per stirpes* (sec. 1180).

(2) *Decedent leaves surviving spouse, no children or grandchildren, but parent or parents*: surviving spouse takes \$5000 plus one half of residue of estate; each parent takes one half of the balance, or, if but one parent survives, he or she takes entire balance.

(3) *Decedent leaves parent or parents, but no spouse, children or grandchildren*: parents each take one half of the whole, or if but one parent survives, he or she takes entire estate.

(4) *Decedent leaves surviving spouse, but no descendant, parent, brother or sister, nephew or niece*: surviving spouse takes entire estate.

(5) *Decedent leaves surviving spouse, no descendant or parent, but a brother or sister, nephew or niece*: surviving spouse takes \$10,000 plus one half of residue, and balance is distributed to brothers and sisters, or their representatives (nephews, nieces, and so on), *per stirpes*.

(6) *Decedent leaves no surviving spouse, but children or grandchildren*: entire estate goes to children or grandchildren in equal parts, *per stirpes*.

(7) *Decedent leaves no surviving spouse, no children or grandchildren, and no parent*: entire estate is distributed to next of kin in equal degrees to deceased. If all brothers and sisters of intestate be living, the whole descends and is distributed to them. If any of them be living and any be dead, the estate goes to the brothers and sisters living, and to the descendants in whatever degree of those who are dead, *per stirpes*, and not *per capita*.

(8) *Adopted children* take the same share as natural children.

1180. Per stirpes v. per capita. When persons take *per stirpes*, they take as representatives of the same ancestor. When they take *per capita*, they take in their own right equally with others.

Example: A decedent leaves no spouse, no children or grandchildren, no parent, a brother, and three nephews by a deceased sister. If the distribution were *per capita*, the brother and each nephew would take one fourth of the estate. However, under the law applicable to this case (see subd. (7) of sec. 1179) the distribution is *per stirpes*: the brother takes half, and each nephew takes a third of the half which the sister would have taken were she alive.

When distributees are in equal degree to the deceased, they take *per capita*; when they are of unequal degrees of kindred, they take *per stirpes*.

Example: In the previous example, if the brother were also deceased, leaving two nieces in addition to the three nephews left by the deceased sister, these nephews and nieces, being of equal degree of kindred to the

deceased, would take *per capita*, instead of *per stirpes* as in the previous example.

D. Executors and Administrators

1181. Executor, administrator and trustee, defined and distinguished. An executor is a person named in a will to execute or carry out its terms. An administrator is a person named by a court to administer the estate of a person who dies intestate. The authority of an executor is derived from the testator himself; of an administrator, from the Court. The duties of an executor differ from those of an administrator, in that the former are defined by the will, and the latter by law. An executor must pay the debts of the estate and distribute the assets as directed by the will; an administrator must pay the debts of the estate and distribute the assets as required by law under the rules of intestate succession (sec. 1179). An executor may be exempted by will from the requirement of filing a bond; an administrator is required by law to furnish a bond in any event.

Testamentary trustees differ from executors and administrators in that the functions of the latter are confined to collecting and preserving assets and to paying debts and legacies (sec. 1188), whereas the trustee's function is primarily to invest, manage and distribute income on the trust fund created by the will, in accordance with the terms of the trust, and upon its conclusion to dispose of the principal or *corpus* as directed. (The nature and duties of a trustee are more fully considered in the next chapter.)

1182. Executors and administrators: who are competent to act. Generally speaking, all persons competent to make a will are competent to act as executors and administrators. The statute usually prohibits certain classes of persons from acting as an executor or administrator, such as (a) persons hostile to or adversely interested in the estate, (b) persons indebted to the estate, (c) persons without means, such as bankrupts or insolvents, (d) illiterate persons, (e) nonresident aliens, (f) nonresidents who are not by law required to give a bond, (g) persons under the age of twenty-one years, (h) adjudged incompetents, (i) felons and (j) persons incompetent to execute

the duties of such trust by reason of drunkenness, dishonesty, improvidence or want of understanding.

1183. Classification of administrators. There are six classes of administrators:

(1) *Ordinary administrator*, appointed by the court in the usual situation, where a person dies intestate.

(2) *Administrator with the will annexed*, a person appointed by the court to carry out the terms of a will which fails to designate an executor.

(3) *Administrator de bonis non*, or substitute administrator appointed by the court when an administrator for some reason or other fails to qualify, or dies, or becomes incapacitated.

(4) *Temporary administrator*, or one appointed by the court on application of a creditor or person interested in the estate when, for any cause, delay occurs in the granting of letters testamentary, or letters of administration, or in probating a will.

(5) *Ancillary administrator*, or one appointed in another state than the one where the will is probated, by reason of the fact that the testator or intestate leaves property in such other state.

(6) *Public administrator*, appointed in a case where there is no personal representative or next of kin in the jurisdiction willing or competent to act as administrator.

1184. Administrators: priorities in right of appointment. In establishing the right to appointment as administrator, personal representatives (sec. 1177) of the deceased are generally entitled to priority in a given order. The order, which may vary slightly in the different states, is generally as follows:

- (a) Surviving husband or wife.
- (b) Children.
- (c) Grandchildren.
- (d) Father or mother.
- (e) Brothers or sisters.
- (f) Any other next of kin entitled to share in the distribution of the estate, preference being given to the person entitled to take the largest share in the estate.
- (g) If any or all of the above persons are infants, or have been adjudged incompetents, or have died, and if no competent adult entitled to take or share in the estate and having a prior right to appointment will accept the same, administration may be granted to the general guardian of an infant, the committee of an incompetent, or the legal representative of a deceased distributee.

(h) If several persons have an equal right to be appointed

administrator, the law may give no preference on account of sex, but that person must be appointed who will in the judgment of the surrogate best manage the estate. Authority to act as administrator may under certain conditions be granted to several persons jointly.

1185. Creditors as administrators. A creditor may be appointed as an administrator when all persons otherwise entitled, including the public administrator, fail or refuse to qualify. Next of kin are unlikely to apply for letters of administration when it becomes evident that the estate is inadequate to yield a surplus over debts. In such circumstances, unless a creditor applied for letters of administration, creditors' claims would be lost for want of an administrator. Administration has been granted to a creditor in preference even to the next of kin, when it has been made to appear that the estate of the decedent was insolvent or barely sufficient for the payment of debts.⁷

1186. Qualification of executors and administrators: objections. An executor or administrator is not qualified to act as such until he has executed and filed the written oath required by statute, and until he has filed his bond, except when he is not required to file a bond (sec. 1181). Any person interested in the estate may, prior to qualification, file objections to the designation of a proposed executor or administrator, on any of the grounds listed in section 1182, or because such designation conflicts with the order of priority shown in section 1184.

1187. Letters. The authority officially granted to an executor or administrator to act as such, takes the form of "letters." *Letters testamentary* are granted to an executor, *letters of administration* to an administrator. When the deceased leaves property in another state, *ancillary letters* must be issued before such property may be taken over and distributed; *ancillary letters testamentary*, when there is a will, and *ancillary letters of administration* when there is no will.

E. Estate Administration

1188. Purpose of estate administration. In general, the purpose of estate administration is to carry out the legitimate directions of the testator in the case of a will, and regardless

⁷ 33 *Corpus Juris Secundum* 937.

of the existence of a will to discover and collect assets, to conserve them pending distribution, to pay all proper claims and taxes, and to make ultimate distribution to those entitled to it. In the case of a will without trust provision, distribution follows the payment of debts, taxes and expenses. When the will creates a trust, distribution is deferred (so far as concerns the principal of the trust) until the terms of the trust are fulfilled.

1189. Fiduciary character of estate management. "An executor or administrator occupies a position of the highest trust and confidence and is required to use reasonable diligence and act in entire good faith in performing the duties of his trust. He is not a guarantor or insurer of the safety of the estate, nor is he expected to be infallible, but the prudence, care, and judgment which one of fair average capacity and ability exercises in the transaction of his own business or, as sometimes stated, the prudence, care, and judgment of fiduciaries ordinarily capable under like circumstances furnish the standard by which his conduct is to be judged."⁸

1190. General authority and duties of executors and administrators. "The general duties of an executor or administrator are to bury the decedent, collect his effects, preserve them from waste, pay claims against the estate, and distribute the residue, if any, among those entitled, and to do all other things necessary as representative of the personal estate of decedent. His powers are controlled by statute and, in the case of an executor or administrator with the will annexed, by the will; and he has no implied powers beyond those which are necessary to the exercise of the powers which are expressly conferred upon him."⁹

1191. Duties prior to appointment and qualification. Although an executor or administrator has no official authority prior to qualifying as such, he may be called upon to make certain necessary arrangements, such as those for burial of the deceased, before qualifying for his duties. When a person dies, it is customary to ascertain, first, whether he left a will, and if so, the identity of the executor named in the will. If there is a will, all preliminary steps are taken by or on behalf

⁸ 24 *Corpus Juris* 48.

⁹ 23 *Corpus Juris* 1169-70.

of the executor named; otherwise, application must be made for the appointment of an administrator.

Safe deposit box. If the testator maintained a safe deposit box, it may be necessary to obtain a court order permitting some party interested to gain access to the box. Such permission is governed by statute. In New York, for example, permission is not granted unless ten days' notice of the time and place of obtaining such access is given to the Tax Commission. A representative of the Tax Commission must be given an opportunity to examine the securities, deposits or assets contained in the safe deposit box at the time it is opened. A safe deposit company may become liable for unpaid taxes and a penalty of not less than \$5000, nor more than \$25,000, for permitting access to the safe deposit box of a decedent without proper authority and without due notice to the Tax Commission.

1192. **Inventory and appraisal.** “. . . the first duty of an executor or administrator as relates to the probate court is, after obtaining his credentials, to prepare and file an inventory of the assets of the estate, and an appraisal of the value of such assets.”¹⁰ This rule is more honored in the breach than in the observance, principally because of the duplicatory requirement of an inventory for estate tax purposes and the complete schedules which must be filed in connection with the final accounting (sec. 1210).

1193. **Discovery and collection of assets.** An executor or administrator must take all steps necessary to discover and collect all the assets of the decedent in order that there may be a complete distribution of the decedent's property and goods. If necessary, he may bring a suit in equity for discovery against any person who, he has reason to believe, has in his possession or under his control any assets belonging to the estate. If the decedent had any contract or other property rights or *choses in action* (sec. 1054), the executor or administrator may bring suit for the recovery of a judgment on behalf of the estate; and upon recovering such judgment, the proceeds become part of the assets of the estate.

Legal v. equitable assets. Formerly, a distinction was drawn between the legal and equitable assets of an estate, that is, between those which a creditor might proceed against in a court of law and those which a creditor might reach in a court of equity only. This affected the order of priority among creditors. Today, this distinction has been superseded by statutes fixing the order of priority among all creditors, regardless of the character of the assets (sec. 1206).

¹⁰ 23 *Corpus Juris* 1158-9.

Bank accounts; stocks and bonds. One of the first steps of an executor or administrator in the collection of assets is to transfer all bank balances standing in the decedent's name, to the name of the estate, followed by the name and designation of the executor or administrator. Before effecting the change, banks usually require a waiver from the tax department, a certified copy of the letters which have been issued (sec. 1187), and sometimes a death certificate. Similarly, stocks and bonds in the decedent's name are transferable on the books of the corporation to the name of the estate and executor or administrator, upon requirements similar to those governing the transfer of bank accounts.

Insurance. When life insurance is payable to a named beneficiary other than the estate, it does not pass through the estate, but is payable directly to such beneficiary. When, however, the insurance is payable to the estate, the executor or administrator must promptly present proof of loss (death), with such other documents as the insurance company may require.

When a testator's property is covered by insurance policies, the executor must cause such policies to be transferred promptly to the name of the estate or the executor acting on its behalf, so that the policies will be enforceable in case of loss.

1194. Right to continue business. Ordinarily, an executor or administrator may not continue a decedent's business, and if he does so, he becomes chargeable with all losses incurred and profits made.¹¹ His duty is to collect, convert and distribute with reasonable dispatch. In doing this, however, an executor or administrator must act with discretion; he may continue the business for the purpose of collecting existing commitments, and to the extent reasonably necessary to avoid too drastic a loss.

Specific authority by will. An executor may be specifically authorized by will to continue the decedent's business. In such case, he will not be liable for losses, if he acted "in good faith and with ordinary prudence."¹²

Partnerships. As noted in section 693, death dissolves a partnership, unless the partnership agreement specifically provides to the contrary. Partners may provide in their articles of copartnership, or by will, that upon death of any partner, his interest in the firm shall continue, through his executor, for a specified period or a specified purpose.

1195. Contracts on behalf of estate. Contracts of an executor or administrator, though made on behalf and in the interests of the estate, are not binding on the estate until they are approved by the Court, usually by order approving the executor's account (sec. 1210). Estate fiduciaries cannot be regarded as

¹¹ 33 *Corpus Juris Secundum*, 1171. See, especially, *Carter v. Carter*, 247 Ala. 409, 24 So. 2d 759.

¹² 33 *Corpus Juris Secundum*, 1175.

agents of the estate; an agent must have a principal, and in no sense can an "estate" be regarded as a principal, since it is neither a natural nor an artificial person. Estate fiduciaries are really trustees for the estate beneficiaries. As such, they are primarily liable on estate contracts, with authority to satisfy these contracts out of estate assets upon approval by the court, an approval that depends upon whether or not the contracts are necessary for a proper administration of the estate, or further existing commitments. To this extent, contracts of executors and administrators may be said to "bind" the estate.

Example: Brady, a wholesale grocer, ordered a large quantity of perishable fruit. A week after his death the fruit was unloaded at the dock, awaiting shipping directions and payment of accrued charges. The executor's contract to take care of these matters upon prompt shipment of the fruit was binding on the estate; but an arrangement with the produce merchant for new shipments over the succeeding three months' period was not.

Persons dealing with an executor or administrator are charged with knowledge of their legal limitations.

Borrowing money. An executor or administrator who borrows money for the estate is personally liable therefor. However, if the money was needed and used for estate purposes, the estate may be properly charged with the loan, and the executor or administrator may be credited with it accordingly.

1196. Legal, accounting and other services. An executor or administrator may engage such legal, accounting and other assistance in the administration of the estate as is reasonably necessary. What is or is not reasonably necessary will depend on the nature, character and size of the estate, the ease or difficulty of collecting and administering the assets, the necessity or nonnecessity of bringing legal proceedings, the existence or nonexistence of substantial accounting problems, and so on. In any event, the expenses incurred by an executor or administrator are at his own risk, since he is primarily liable for such expenses. Unless they are subsequently approved by the court, he may be *surcharged* for them, that is, required to account for them to the estate out of his own funds.

1197. Making and indorsing commercial paper: guaranty and suretyship. Ordinarily, an executor or administrator has no authority to impose liability on an estate by giving or indorsing a note or accepting a bill of exchange. When he does so, though signing as executor or administrator, he may become

personally liable. However, some cases make a distinction between giving a note which merely extends a pre-existing commitment and giving a note which imposes new liability on the estate.

Example: An executor may properly renew a testator's note so as to afford the estate more time to pay it.¹³

Accommodation indorsement. An executor has no right to indorse a renewal note on behalf of the estate, though the original note was indorsed for accommodation by the testator, unless such indorsement is necessary and beneficial to the estate. (See sec. 1800.)

Guaranty and suretyship. An executor or administrator has no implied authority to bind the estate by a guaranty or suretyship, even where such undertaking is given to support an existing liability of the decedent. If such undertaking is given, the executor or administrator becomes personally liable.

1198. Liability for torts. Since executors and administrators cannot be regarded as agents for an estate (sec. 1195), they cannot by their torts impose liability upon the estate but are personally liable for their torts though committed while they were acting on behalf of the estate.¹⁴

Example: A decedent, at the time of his death, had property in his possession as bailee, which the executor subsequently refused to give up. The owner sued the executor as such, for conversion (sec. 29). The Court held that the action must be brought against the executor personally, not as representative of the estate.¹⁵

1199. Familiarity and compliance with will. An executor must be familiar with the provisions of the will so that he may know exactly what the testator's wishes are in connection with the custody, management and distribution of the estate, and so that he may fully comply with such wishes. He is not permitted to use his own judgment and discretion in opposition to a specific direction by the testator.

Example: If a testator leaves a farm and directs the executor to sell it and turn over the proceeds to a trustee who is to invest such proceeds, both the executor and the trustee will be personally liable if the former turned the farm over to the trustee without selling it, and the latter continued to manage the farm without converting it into funds for investment.

¹³ *First Nat. Bank of Salem v. Jacobs*, 85 W.Va. 653, 102 S.E. 491.

¹⁴ *State, for the Use of Skinner v. Redding*, Del. Super., 45 A. 2d 507; *Ernest G. Beaudry, Inc., v. Freeman*, 73 Ga. App. 736, 38 S.E. 2d 40; *Christensen v. Frankland*, 324 Ill. App. 391, 58 N.E. 2d 289, 292; *Ostheimer v. McNutt*, Ind. App., 66 N.E. 2d 142; *Premium Cut Beef Co. v. Karp*, 318 Mass. 229, 61 N.E. 2d 112; *Brown v. Mack*, 185 Misc. 368, 56 N.Y. Supp. 2d 910.

¹⁵ *Watson v. Moriarty*, 59 N.Y. 573.

1200. Duties of accountant or auditor. As noted in section 1196, an executor or administrator may engage the services of an accountant, when reasonably necessary to a proper administration of the estate. The duties of such accountant or auditor will relate to the administration and disposition of estate assets and to a proper accounting by the executor or administrator in connection therewith (sec. 1210). Accounting records should be set up so as to reveal:

- (A) The principal of the estate, including
 - (1) Original assets received by the executor upon which he makes up his inventory (sec. 1192).
 - (2) Assets discovered and collected after making up the inventory.
 - (3) Proceeds from the sale of real property.
 - (4) Increase in capital assets from any cause.
- (B) Reduction in accountability for principal, including
 - (1) Decrease in value of capital assets through natural or other shrinkage, deterioration, damage, or loss from any cause.
 - (2) Administration and funeral expenses chargeable to principal.
 - (3) Uncollectible assets.
 - (4) Creditors' claims paid.
 - (5) Distribution of legacies, and so on.
- (C) Accountability for income (Gross income from real and personal property, separately shown)
- (D) Reduction in accountability for income, including
 - (1) Administration expenses paid and chargeable to income.
 - (2) Amounts paid to life beneficiaries of trust funds (sec. 1262).
 - (3) Operating and maintenance expenses.
 - (4) Interest or premiums accrued or paid on investments.

For an intelligent and adequate setup of records bearing on the above items, an accountant should be familiar with the salient provisions of the will, including any trust provisions, specific legacies or bequests, the legatees to whom they are made, and so on. (See section 1794, subd. (c).)

1201. Liability for shrinkage in assets. An executor is liable for shrinkage in estate assets only when such shrinkage is due to his neglect or violation of duty. Thus, an executor, like a trustee, is limited by law to certain investments (sec. 1256), though such investments should be temporary only, pending administration and liquidation of the estate. If he invests estate assets otherwise than as provided by law, he is personally liable for any consequent loss or shrinkage. An executor must not allow estate funds to remain unnecessarily idle; if he does, he is chargeable with interest he might have earned in the in-

terim. Whether they are unnecessarily idle, that is, whether to keep funds readily available or to deposit them in interest-bearing accounts, is largely a matter of discretion with the executor. However, if such discretion is tinged with personal motive, the executor is liable for mishandling of estate funds.

Example: An executor filed his final accounting two years after his initial inventory. In the interim, estate bonds depreciated in value, resulting in a shrinkage of principal to the extent of \$10,000. The executor had also transferred substantial estate funds from a bank paying 4% interest to a bank (of which he was president) allowing only 2%. For the shrinkage in bonds, the executor would not be liable unless the period of shrinkage was marked by unreasonable delay in administering the estate. But for the loss of 2% interest the executor, whose conduct was obviously motivated by self-interest, would be personally liable.

An executor is not liable for shrinkage in estate assets, if he complies with the specific wishes of the testator in retaining existing assets without converting them into safer or more liquid form. (See sec. 1256.)

1202. Commingling of funds. An executor, administrator, guardian or testamentary trustee must keep estate funds and property separate and apart from his own account. If he fails to do so, he is liable by statute in many states for a misdemeanor; and in addition he is liable for any loss or shrinkage of such funds, by bank failure or otherwise, while the funds are so commingled. Improper designation of a deposit may be tantamount to commingling.

"Designation of deposit. The representative should make the deposit with a designation of his fiduciary capacity, and if the deposit is made in his individual name, without any designation of the trust, he is liable for any loss which results from such disposition of the funds, regardless of any question of negligence or intention in making the deposit in such form, and it is not material that he had at the time no money of his own deposited in the bank or that he informed the bank, at the time of the deposit, that the funds belonged to the estate."¹⁶

1203. Property available for payment of debts: real v. personal. Although all property in the estate is subject to debts, personal property must be applied first, and then the realty. A testator, however, may, if he wishes, direct otherwise. Hence if a testator wishes his real property to be applied first in payment of debts, or equally with his personal property, he

¹⁶ 33 *Corpus Juris Secundum* 1166-67.

should so provide in his will; otherwise, devisees may benefit at the expense of the legatees (sec. 1208). In some states, an administrator is given specific statutory authority to take possession of real property, manage it and collect rents, thereby giving creditors protection which does not exist at common law where real property, under intestacy, goes directly to heirs without passing through the estate. (See sec. 1803.)

1204. Time limit for presenting claims. Statutes in the different states generally fix a time limit within which creditors must file their claims, or be without remedy against an executor or administrator as to assets which have been distributed. For example, in New York, if a claim is not presented within seven months from the date letters were issued (sec. 1187), the executor or administrator is not chargeable for any assets or moneys paid in satisfaction of other claims, or to any beneficiaries or distributees of the estate. The executor or administrator, if he wishes, may shorten this period by one month, by advertising for claims.

1205. Actions and proceedings against estate. Just as an executor or administrator may bring suit on behalf of an estate for the recovery of a judgment in its favor, so creditors and claimants generally may sue the executor or administrator, as representing the estate, in connection with any cause of action against the decedent which survives his death. For example, if a decedent breached a contract, his estate is liable. However, statutes in most states generally require that a creditor must first get leave of the probate court before he may sue an executor or administrator on a claim against the estate. If no executor or administrator has been appointed, a creditor may, as previously noted (sec. 1185), petition for letters himself.

1206. Payment of debts and claims: order of priority. The order of priority in the payment of debts of an estate is now governed by statute, which may vary as to detail in the different states. Administration expenses always come first. Then, generally, come claims preferred by Federal and state laws, government claims, secured claims, and, finally all others. Thus, in New York, the order is: (a) debts entitled to preference under United States and state laws, (b) taxes assessed on property of the deceased before his death, (c) judgments according to priority of docketing (filing), and (d) all other debts.

As among creditors of the same class, there is no preference; they share *pro rata*.

Example: A creditor holds two notes made by decedent, one which matured before the latter's death, and another after. The first note is not entitled to priority over the second, unless it was reduced to judgment. (See sec. 1804.)

But the same creditor may hold two claims against the estate, one entitled to preference over the other.

Example: An accountant has two claims against the estate, one for services rendered decedent before his death, the other for services rendered in connection with the administration of the estate. The latter claim is entitled to priority as an administration expense of the estate.

Claims limited to specific assets. When creditors extend credit to a business conducted and continued by an executor under a decedent's authorization, they must look, for satisfaction, to the business and to the funds invested therein; they cannot look to the estate itself.¹⁷

1207. Distribution of estate: net assets. Only net assets after payment of debts are distributable. Debts have priority over legacies. "A testator must be just before he is generous." Thus, if there are not enough assets in the estate to pay expenses, debts and legacies in the amounts specified in a will, the legatees' shares will be reduced proportionately.

Provisions for distribution exclusive of taxes. Taxes must be apportioned among all beneficiaries. A testator may, however, make provision for bequests exclusive of taxes, by directing that taxes shall be payable out of the residuary estate.

Example: "I direct that the legacy to Mary Smith shall be paid without deduction therefrom of any taxes, but that estate taxes payable thereon shall be payable out of my residuary estate."¹⁸

1208. Devises and legacies (bequests). A *devise* is a disposition of real property by will. The recipient of a devise is a *devisee*. A *legacy* is a disposition of personal property by will. It is also known as a *bequest*. The recipient of a legacy is known as a *legatee*. Legacies are of various types.

¹⁷ "In the case at bar the executor was authorized to continue the business. He was not authorized, however, to involve the general assets of the estate; therefore, persons dealing with him were bound to know that they could resort only to the property embarked in the business." *Manhattan Oil Co. v. Gill*, 118 App. Div. 17, 19. See also, *Willis v. Sharp*, 113 N.Y. 586, 590; *Furst v. Armstrong*, 202 Pa. 348, 51 A. 996; *Hake v. Dilworth* (Tex. Civ. App.), 96 S.W. 2d 121.

¹⁸ Or "shall be borne proportionately by all my devisees and legacies" (where the testator does not wish to burden the residuary legatee unduly).

General legacies. A legacy is general when it does not dispose of a particular thing or things.

Examples:

- (1) A bequest of \$5000.
- (2) A bequest of "Ten Upland Water Company bonds of the par value of \$1000 each."

A general legacy begins to bear interest when it is payable, not before.

Example: A legacy of \$10,000 was payable to a grandchild upon his reaching the age of twenty-one years. He contended that he was entitled to interest from the date the fund was established. The court held that interest on such legacy was not payable until the legacy itself was payable.¹⁹

Specific legacy. A legacy is specific when it disposes of a particular thing or things.

Examples:

- (1) A legacy of some keepsake or item of jewelry, such as a watch or a diamond ring.
- (2) A bequest of "my ten Upland Water Company bonds of the par value of \$1000 each."

Ademption v. abatement. "Ademption" relates to the extinguishment or revocation of a legacy, "abatement" to its reduction. Thus, a special legacy is payable only in case the subject matter is in existence at the testator's death, that is, it is subject to *ademption*. A general legacy, however, is not dependent upon the existence of a particular thing at the time of the testator's death, but is payable absolutely, though subject to *abatement* if the assets are insufficient to pay it in full. Thus, where the bequest was of "my ten Upland Water Company bonds" (specific), the legatee would take nothing if the testator had no such bonds at the time of his death. If the bequest were of "ten Upland Water Company bonds," and the testator had no such bonds, the executor would be required to provide them for the legatee. If the assets were insufficient to provide such bonds in full, the legacy would be subject to abatement, that is, the general legatee would receive proportionately less (unless the will provided otherwise).

Demonstrative legacy. A demonstrative legacy is one payable primarily out of a particular fund, with the provision that if the fund designated fails, the legacy shall be payable out of general assets.

Lapsed legacy. A lapsed legacy is one payable to a legatee who dies before the testator or before the legacy is payable. Under the common law, such legacy would fail. Today, such legacy would not fail if the legatee is either a child, grandchild, brother or sister of the testator, provided such legatee, upon predeceasing the testator, leaves a child or other descendant surviving (sec. 1805).

Residuary devisees and legatees. A residuary devisee or legatee is one to whom, respectively, the balance or residue of real or personal property is devised or bequeathed, after the making of general and specific devises or bequests.

¹⁹ *Matter of Hier*, 205 App. Div. 215, 199 N.Y. Supp. 623.

Guardians in probate proceedings. Reference has already been made to testamentary and special guardians (sec. 25). Probate courts jealously guard the funds and affairs of infants. The duties of guardians in probate proceedings are correspondingly strict, particularly where the guardian is entrusted with an infant's funds. Under the common law, a married woman could not be appointed a guardian; and an unmarried woman was likewise disqualified by her subsequent marriage. This rule is no longer applicable. Thus, if a maiden aunt is appointed guardian for her niece, her subsequent marriage will not terminate her guardianship.²⁰

Interest on legacies and trust funds. See section 1266.

1209. Insolvent estates. The executor or administrator of an insolvent estate owes a fiduciary duty (sec. 562) to general creditors and holds the property of the estate in trust for them. The probate court retains jurisdiction over insolvent estates. A decedent's estate cannot be forced into bankruptcy. The Bankruptcy Act, in specifying what persons may be adjudged involuntary bankrupts, provides (sec. 4, subd. d) that "any *natural person*" may be adjudged an involuntary bankrupt, thereby excluding decedents.

1210. Accounting and settlement. Reference has already been made to the general nature of the accounting records which should be maintained by an executor or administrator, in order that he may properly record and reflect the assets entrusted to him and his administration of such assets and the affairs of the estate. (See sec. 1200.) The extent of these records will depend on the degree of accountability necessitated by the nature and extent of the estate. An executor or administrator has concluded his duties when he has distributed the estate property, after he has paid all expenses and taxes, and has paid, compromised or caused to be legally dismissed all claims against the estate. Upon the conclusion of such duties, it is customary for the executor or administrator to render an accounting and to procure an order or decree for the judicial settlement of such accounts as final and binding upon all parties. Such an order may be procured only after notice to all parties interested in the estate. Upon procuring such judicial settlement, the executor or administrator may have his bond canceled, and the estate is thereby closed. If the testator has set up trusts to be administered, the executor, in making distribution, will transfer the trust property to the trustee, who, in turn, must fully account to the Court in respect to his

²⁰ *The Guardianship of Mary Elgin*, 1 Tuck. (N.Y.) 97.

administration and distribution of the trust property. This phase of estate administration is discussed in the following chapter (sec. 1259).

Questions and Problems for Review

1. Define will, nuncupative will, holographic will, codicil. *NY June 1916 (9)*
2. Who may make a will? *NY Apr. 1934 (4)*
3. A, an infant, was nineteen years old at the time he executed his last will and testament by which he disposed of realty and personalty effective at the time of his death. At the time of his death A was twenty-three years old. Is the will valid? Give reasons. *NY Nov. 1929 (14)*
4. What share does a child receive in the personalty of his father if the father died leaving a will in which no provision was made for that child? *NY May 1930 (6); NY May 1928 (6)*
5. What is meant by the term *nuncupative will*? By whom may it be made? To what class of property does it apply? *NY May 1927 (10)*
6. Who may petition for the probate of a will and what proof must be adduced when the same is presented for probate? *NY May 1925 (7)*
7. What is the law in this state respecting the distribution of the personal property of a decedent, dying intestate, if he leaves (a) a widow and children, (b) a widow but no children, (c) a widow but no descendants, brother, sister, nephew or niece? *NY Jan. 1924 (10); NY June 1919 (15)*
8. Define briefly the difference in the division of an estate between a *per capita* and a *per stirpes* basis. *NY Jan. 1923 (10)*
9. From whence do executors and administrators derive their authority? In what particulars do their duties differ? *NY Jan. 1923 (11)*
10. Who are prevented from acting as executors or administrators under a will? *NY Jan. 1925 (12)*
11. Name three classes of administrators of a deceased person's estate. Distinguish as to duties between an ordinary administrator and a trustee named in a will. *NY May 1927 (9)*
12. Define (a) executor, (b) administrator, (c) letters testamentary, (d) ancillary letters. *NY Jan. 1926 (11)*
13. What is the first and most essential duty of an executor upon receiving his credentials from the probate court? *NY Jan. 1925 (7); NY Jan. 1922 (5)*

14. Distinguish between legal and equitable assets. *NY Apr. 1934 (3)*

15. Carlin borrowed \$10,000 from White for one year, giving as security a mortgage upon real estate.

(a) Six months later, Carlin died. At the maturity of the loan, what rights had White and against whom could he enforce them?

(b) If White instead of Carlin had died six months after the loan was made, to which of the following persons should Carlin make payment at maturity—White's legatees, heirs, testamentary trustee, administrator, next of kin, executor, devisees? *AI Nov. 1931 (3)*

16. George Smith died in October 1910. His executor filed his inventory of the estate in July 1915 and his final accounts in February 1917. Between the date when the inventory was filed and that on which the accounting was submitted to the Surrogate's Court certain bonds received by the executor as a part of the corpus of the estate depreciated in value, so that there was a shrinkage in the corpus of the estate to the amount of \$10,000. It further appeared that the executor on taking charge of the estate found that the testator had a large balance in the bank on which the bank allowed 4% interest, payable semiannually. Smith was himself president of another bank in town, so had the balance belonging to the estate transferred to his own bank and allowed the estate 2% interest, whereas the estate was receiving 4% from the testator's bank. Is the executor liable for the shrinkage in assets and also for the loss in interest? Give reasons. *NY Jan. 1923 (5)*

17. Is it proper, or even permissible, for an executor, administrator, guardian or testamentary trustee, to deposit money received by him as part of the estate of the decedent, in his own bank account, which stands in his individual name? Reply fully, giving reasons. *NY Jan. 1925 (9); NY Jan. 1922 (1)*

18. In what order is X, the administrator with the will annexed (estate of A), required by law to pay the debts of A? *NY May 1929 (9)*

19. John Smith died leaving an estate of \$500,000 in realty and securities. At the time of his death he was conducting business as a banker and broker. William Jones, his partner, was named in the will as executor, with power to continue the business for a period of five years. The lack of Smith's knowledge and influence soon caused the business to fall off and it was eventually wound up.

The remaining assets were insufficient to pay the debts, and several of the creditors commenced an action against William Jones, as executor for the amount of their claims, alleging that as executor he should satisfy unliquidated claims from the corpus of Smith's estate. Will they succeed? Answer fully, giving reasons. *NY June 1922 (2)*

20. A testatrix bequeathed "ten Upland Water Company bonds of the par value of \$1000 each to my niece Mary." She never owned

bonds of that name and denomination, but did own ten bonds of another water company of the par value of \$500 each. Is such a bequest a general or a specific legacy? *NY June 1924 (10)*

21. Illustrate lapsed legacy. *NY Nov. 1928 (1)*

22. A maiden aunt is appointed guardian for her niece, the child of a deceased sister. As such guardian she is entrusted with the care and dispensing of a large income from an estate. Two years after her appointment, the aunt marries. What, if any, effect does her marriage have on her duties as guardian? *NY Jan. 1923 (12)*

CHAPTER XV

Trusts

1211. Scope of chapter. In this chapter we consider the nature of the trust relationship, and how it is to be distinguished from similar relationships; the different kinds and classifications of trusts; the subject of express trusts, including the parties thereto, the requisites of such trusts, how they may be created, and some particular forms which they may take; the subject of implied trusts, including resulting and constructive trusts; trustees and trust management, including the qualification, powers, rights, duties and liabilities of trustees, the apportionment of expenditure between capital and income, trust investments, and the distribution of trust property; accounting and settlement of trust estates; and, finally, the circumstances under which a trust may be terminated and the trustee removed or discharged.

A. Definitions and Distinctions

1212. Nature of trust. A trust in the broadest sense is a confidence. Such confidence may or may not involve specific property; it may or may not create legal rights and duties. In the legal sense, however, a trust always involves specific property and creates rights and duties. It involves property held by one person for the benefit of another, the latter having a right in equity to compel the person in whom the confidence is reposed to discharge his obligations in respect to the property.

Definition. A trust may therefore be defined as a confidence reposed in one person with respect to property held by him for the benefit of another.

1213. Parties to trust. Every trust involves three parties: the person who creates it, the person in whom legal title is vested, and the person for whose benefit the trust is created.

Donor. The person who creates or establishes a trust is called a *donor* (also *trustor, settlor, creator, founder*).

Trustee. The person in whom legal title to property is vested for the purpose of fulfilling the terms of a trust is known as the *trustee*.

Beneficiary. The person for whose benefit the trust is created is known as the *beneficiary*, or *cestui quie trust*.

1214. Trust property: legal and equitable interests. Every trust involves two estates or interests in the subject matter of the trust: the *legal* estate, or interest held by the trustee for administrative purposes, and the *equitable* estate, or interest of the beneficiary which entitles him to the benefits of the trust. The latter is enforceable only in a court of equity.

Examples:

(1) A conveys certain real property to X in trust for B. X, the trustee, has the legal title, that is, the title recognized in a court of law, but B has the *beneficial* or *equitable* title, that is, the title recognized in a court of equity.

(2) A establishes a fund with the University Trust Company for the benefit of the Metropolitan University. The Trust Company, as trustee, has the *legal* (administrative) interest and the university the *equitable* (beneficial) interest.

1215. Trust distinguished from agency and partnership. As pointed out in section 546, an agency differs from a trust in at least three respects, namely, (1) as to title in the subject matter, (2) as to the person in whose name the acts are performed, and (3) as to revocability; and since every partner is an agent for the firm, the distinction between a partner and a trustee is similar to that between an agent and a trustee. However, the assets of a partnership constitute a trust fund for the protection of creditors and to this extent partners may be deemed trustees. Surviving partners also occupy the position of trustees in respect to the estate of a deceased partner; and upon dissolution of a firm, partners are trustees in respect to creditors and in respect to one another in liquidating the affairs of the firm (sec. 700).

1216. Trust *v.* bailment. Trusts are distinguishable from bailments in two respects: (1) a trust confers legal title, whereas a bailment transfers possession only, and (2) a trustee need not return the identical property coming into his hands, but need only *account for* such property or its equivalent, whereas a bailee must return the *identical* property, either in the same or in altered form.

1217. Trust *v.* debt. A trust differs from an ordinary debt in four important respects:

(1) *Nature of obligation.* A debtor merely owes his creditor a debt. The relationship is that of a simple contract or business obligation. A trustee owes his beneficiary the highest degree of faith in the discharge of the trust. The relationship is fiduciary.

(2) *Liability for loss.* If trust property is lost or destroyed without the trustee's fault, the trustee is not liable for it; but a debtor remains liable regardless of fault.

Example: If I give you \$500 to invest for me, and the investment results in a loss, I have no recourse against you unless you failed to exercise reasonable judgment; but if I loan you \$500 and you lose the money, you owe me the money whether the loss was negligent or not.

(3) *Rights of creditors in case of insolvency.* When a debtor becomes insolvent, general creditors are entitled only to a *pro rata* share of his assets. If a trustee becomes insolvent, the beneficiary has a prior right to so much of the trustee's assets as represent trust property or its proceeds.¹

Example: A becomes insolvent. His debts amount to \$100,000. He has assets of \$60,000, all on deposit in a bank, including \$10,000 in trust for B. Creditors demand sixty cents on the dollar. B demands his \$10,000 in full. B will prevail.

(4) *Statute of limitations.* The statute of limitations begins to run in favor of a debtor when the obligation matures (sec. 98); but it does not begin to run in favor of an express trustee (sec. 1220) until he openly repudiates the trust.

Moreover, the period of the statute of limitations is usually longer in equity actions (including actions involving a trust) than in an ordinary debt action.

Example: Stock is deposited in trust in 1888. Eleven years later its return is demanded and refused. *Held*, the statute did not start to run until such demand and refusal.²

1218. When bank deposits constitute trust funds. Ordinary bank deposits do not constitute trust funds. They merely establish the relationship of debtor and creditor. However, when a bank accepts a special deposit, it becomes the deposi-

¹ *Easly v. Dye*, 14 Ala. 158; *Byrne v. McGrath*, 130 Cal. 316, 62 P. 559; *Scurry v. Quaker Oats Co.*, 201 Iowa 1171, 208 N.W. 860; *Finnell v. Higginbotham*, 97 Ky. 21, 29 S.W. 740; *Burdeau v. Davey*, 43 La. Ann. 585, 9 So. 752; *Carson v. Phelps*, 40 Md. 73; *Hunnewell v. Lane* (Mass.), 11 Metc. 163; *Patten v. Chamberlain*, 44 Mich. 5, 5 N.W. 1037; *Taylor v. Mosely*, 57 Miss. 544; *Hudson v. Wright*, 204 Mo. 412, 103 S.W. 8; *In re Jamison & Co.'s Estate*, 3 Pa. Dist. 217, rev. on other grounds 163 Pa. 143, 29A 1003; *Mathews v. Massey* (Tenn.), 4 Baxt. 450; *Cochran v. Sonnen* (Tex. Civ. App.), 26 S.W. 521; *Irvine v. Greever*, 32 Gratt. (73 Va.) 411.

² *Treadwell v. Clark*, 190 N.Y. 51.

tor's trustee. In such case, if the bank were to fail, the special depositor would be entitled to a preference.

1219. Trusts *v.* powers. A "power" is a right in any person, created by deed or will of the owner, authorizing such person in turn to create an estate or interest in, or lien upon land, or to convey it for any purpose specified by the owner. The donee of a power, unlike the trustee of a trust, is not given title to the property. Thus, he transmits title without having it himself.

B. Classification of Trusts

1220. Express and implied trusts. Express trusts are those created by direct and positive acts of the parties, in words, oral or written. Implied trusts are those which, without being expressed, may be inferred from the nature of the transaction. Implied trusts are either *resulting* or *constructive*. (See sec. 1248.)

1221. Executory and executed trusts. Executory trusts are those wherein the donor's intentions are imperfectly or incompletely expressed, or not fully declared, so that something remains to be done in order to complete and perfect the trust.

Examples:

- (1) A promise to create a trust.
- (2) Directions given for the execution of some future conveyance or settlement of trust property subject to further instructions.
- (3) A conveyance of property in trust, subject to subsequent instructions.

In an executed trust, the terms of the trust are fully and perfectly declared, the donor has given complete directions for settling his estate, and no further act is necessary to effectuate the trust.

Example: A deed or will creating a trust in terms so clear and certain that a trustee has nothing to do but to carry out the provisions of the instrument.

1222. Other types of trusts. There are numerous other classifications of trust, among them the following:

Active v. passive trusts. An *active* trust, also known as a *special* or *operative* trust, is one which imposes active duties upon the trustee in executing the trust. A *passive* trust, also known as a *simple*, *technical*, *dry* or *naked* trust, is one in which the trustee is a mere passive holder of the property with no duties to perform. (See sec. 1226.)

Discretionary v. ministerial trusts. Discretionary trusts are those wherein the administration of the trust is left to the sole discretion of the trustee. Ministerial trusts are those which involve no discretion on the part of the trustee and merely require that he specifically carry out certain explicit instructions.

Precatory v. mandatory trusts. Precatory trusts are those created by words of entreaty, wish, expectation, request or recommendation, such as the words "hope," "wish," "request," and so on; as distinguished from a trust wherein words of command and obligation are used.

Shifting trusts. Shifting trusts are so created that, under specified contingencies, they may operate in favor of beneficiaries additional to or substituted for those first named.

Spendthrift trusts. Spendthrift trusts are those created with a view to providing a fund for the maintenance of an improvident person, by securing the fund against such person's improvidence or incapacity. (See sec. 1240.)

Living v. testamentary trusts. A living trust is one that is created and comes into existence during the lifetime of the donor. Testamentary trusts are those created by will.

C. Express Trusts: Requisites and Restrictions

1223. Requisites: in general. The requisites of a valid express trust include:

(1) *Subject matter*, or trust *res*, which must be sufficiently identified or identifiable so that it can be appropriated to the trust, and which must represent a legitimate property interest not contrary to law or public policy.

(2) *Parties*: These include the donor, trustee and beneficiary (sec. 1213). A donor and beneficiary are absolutely essential to the trust; but equity will not permit a trust in other respects valid to fail for want of a trustee, and will in such case appoint a trustee.

(a) *Who may be donor.* Every person competent to dispose of his property by contract, deed or will has the power likewise to dispose of it by creating a trust in such property. Since infants cannot dispose of real property by deed or will, they cannot create a trust in such property.

(b) *Who may be trustee.* See section 1250.

(c) *Who may be beneficiary.* Any person may be a beneficiary regardless of age or sex and regardless of physical or mental capacity. Trusts without specific beneficiaries are void, excepting charitable trusts, which necessarily can have no specific beneficiary.

(3) *Consideration.* When the trust is wholly executory, that is, when there is merely an agreement to create a trust not yet in existence, consideration is essential, or the trust is ineffective. An executed trust, like a gift, requires no consideration.

(4) *Certainty.* It is a requisite of every express trust that the intent to create a trust shall be clearly expressed. The declaration of trust must be

sufficiently explicit to designate with reasonable certainty the subject matter, purpose and beneficiary of the trust. Otherwise, the trust is impossible of execution.

Examples:

(1) A trust for the benefit of certain persons, *or either of them*, is void for uncertainty of beneficiaries.

(2) A trust created by a testatrix for the purpose of keeping her burial plot in good condition is void for want of a beneficiary.

(3) A trust for the building of a school house was declared void for uncertainty.³

1224. Restrictions: in general. In addition to the above, the law imposes other essential requirements and restrictions. Among these are the requirements as to *form* in certain cases (for example, that a contract to create a trust must be in writing under the statute of frauds), the requirement that a trust must have an *active purpose* (eliminating “passive” trusts), the “rule against perpetuities” (to prevent tying up property for overlong periods of time), and the rule against the accumulation of income beyond the period measured by a person’s minority.

1225. Trusts and the statute of frauds. As a general rule, trusts need not be *created* by a writing, but must be *manifested and proved* by a writing. This means that even when a trust comes into existence without a writing, it will be sustained if it can be established by a subsequent writing. The writing need be signed only by the donor. It need not be in any particular form, so long as it sufficiently designates the property, the beneficiary and the purpose of the trust. If the writing does not designate a trustee, the court will appoint one. A person complies with the statute of frauds if he declares in writing that he holds property, in any form, for the benefit of another.

Exceptions to statute of frauds. There are two exceptions to the rule that an oral trust is invalid: (1) when an oral trust has been fully or partly executed and (2) implied trusts, including resulting and constructive trusts (secs. 1246-1249).

1226. Trust must be active. A trust wherein the trustee has no active duty to perform and is merely a temporary holder of title—a channel through whom title flows—is ineffective as a trust, and legal title in such cases passes automatically to the

³ *Emory etc. College v. Schoemaker*, 93 Va. 320.

beneficiaries. Passive trusts have been generally abolished throughout the country.

Examples:

(1) Trust wherein the right to both possession and profits vests in the beneficiary.

(2) Trust for the grantor's sole use.

(3) Trust for the sole purpose of conveying title.

1227. Specific purposes for which trusts in real property may be created. Some states, notably Michigan, New York and Wisconsin, have abolished all uses and trusts in lands except such as are expressly authorized by statute. In New York, for example, express trusts in real property are limited to the following six purposes:

(1) To sell real property for the benefit of creditors.

(2) To sell, mortgage or lease real property for the benefit of annuitants (sec. 1057) or other legatees, or for the purpose of satisfying any charge thereon.

(3) To receive the rents and profits of real property, and apply them to the use of any person, during the life of that person, or for any shorter term.

(4) To receive the rents and profits of real property, and to accumulate the same for a period of time not exceeding the minority of an infant.

(5) To effectuate a reorganization plan in connection with real property acquired by the foreclosure of a mortgage against which participation certificates have been issued and guaranteed.

(6) To further some religious, educational, charitable or benevolent enterprise.

Any trust in real property created for any purpose other than the above is void as a trust, though it may be enforceable as a power (sec. 1219).

Trust property in different states: law governing validity. When real and personal property subject to a trust is located in various states, the validity of the trust in so far as it affects the real property is determined by the law of the state where it is located (*lex situs*), and insofar as it affects the personal property, by the law of the donor's domicile. (See sec. 1178.)

1228. Rule against perpetuities: purpose of rule. The object of the rule against perpetuities is to prevent tying up title to property in such a way that for an unreasonable period of time, no one can be pointed to as the person who has the absolute right to transfer title and possession to the property. Such tying up of title is referred to as *suspending the absolute*

power of alienation. The rule generally provides that the *absolute power of alienation* is suspended when there are no persons in existence by whom an absolute fee in possession (secs. 1027 and 1029) can be conveyed. Absolute ownership may be suspended in two ways:

(1) By creating a contingent or uncertain future estate.

Example: Life estate to Jones, remainder to the person who shall be Mayor of the City of New York in 1960. Such remainder is contingent, not vested. It suspends until 1960 the *absolute power of alienation*.

(2) By creating a trust for a specific period. The law does not permit the *power of alienation* or transfer to be suspended for fixed periods but prefers to measure such period by human lives. Hence a trust for ten years in X as trustee for the benefit of A would fail.

1229. Rule against perpetuities: maximum period of suspension. The longest possible period during which the absolute power of alienation may be suspended, whether by future estate or by trust, is a period not measured by time, but by *two lives in being plus the period of minority*.

Example: Life estates in Allen and Baker, remainder to Curtis, an infant born on the day the estate is created; with the provision that if Curtis dies before he is twenty-one or marries before he is twenty-one, or if any other prescribed condition occurs or fails to occur during the twenty-one year period, then the remainder is to go to Dalton. This is the maximum period during which alienation may be suspended: the lives of A and B and the minority of C.

In some states, the maximum period of suspension of the power of transfer is two lives in being without the added minority period. Even in states which add the minority period, it is considered safer to limit the suspension in trust to two lives in being.

1230. Rule against perpetuities: trusts in personal property. The Rule Against Perpetuities applies not only to trusts in real property, but to trusts in personal property as well. However, trusts in personal property are further subject to the rule against accumulations.

Rule Against Accumulations. Trusts in personal property which provide for accumulations of interest upon principal are generally void unless such accumulations are limited to the period of infancy; that is, the accumulation must terminate at or before the expiration of the beneficiary's minority. Stock dividends on stock held in trust are generally treated as principal, not subject to the rule against accumulations. (See sec. 1264.)

D. Express Trusts: How Created

1231. In general. Broadly, there are two ways in which an express trust may be created: (1) by a disposition *inter vivos*, or living trust, namely, one which becomes effective during the donor's lifetime and (2) by a testamentary disposition, which becomes effective after the donor's death (sec. 1222). In the case of a living trust, the donor's disposition may be revocable or irrevocable, depending upon the terms of the trust. A testamentary trust, of course, becomes irrevocable upon the donor's death, though its benefits may shift upon contingencies named in the trust (sec. 1222, "Shifting trusts"). Prior to the testator's death, however, the trust may be revoked at any time, since a will is revocable at the testator's election (sec. 1173).

A person may subject property to a trust in one of two ways: (1) He may transfer the property subject to a trust and (2) he may constitute himself trustee, without any transfer, by a declaration of trust.

1232. Transfer of property: living (*inter vivos*) trusts. Real property may be transferred by deed, subject to trust provisions embodied in the instrument itself; or it may be conveyed by a deed, simultaneously with a trust instrument which sets forth the trust purposes and provisions of the conveyance; or the property may be conveyed by deed to a grantee who in turn agrees to hold or convey the property to the use of another. The same principles apply to personal property transfers for trust purposes; the trust may be embodied in the instrument of transfer itself, in a collateral instrument, or in a written acknowledgment by the transferee that the property is received for specified trust purposes.

1233. Transfer of property: testamentary trusts. Although most wills provide for an outright distribution, many wills, especially by wealthy testators, contain trust provisions of one sort or another. Testamentary trusts may be created (a) by devise, (b) by gift of a specific sum of money, (c) by gift of income-producing personalty, such as securities and (d) by gift to a trustee of all or part of the residuary estate (sec. 1208).

Testamentary trusts and estate taxes. In some states, testamentary trusts are required to bear their share of estate taxes unless the will otherwise provides. Thus, a testator may believe he is creating a \$500,000 trust, whereas the actual amount of the trust after taxes may be substan-

tially less, unless the will contains a provision exempting the trust fund from its proportion of the estate tax.

1234. Advantages of testamentary trust over outright distribution. A testamentary trust has certain advantages over an outright disposition, particularly in respect to (a) infancy, (b) financial safety, and (c) tax economy. .

(a) *Infancy.* An outright devise or bequest to an infant entails limitations and impediments from the standpoint of expeditious administration. The infant himself cannot receive or manage the property, hence a guardian must be appointed. This involves guardianship expenses (in procuring and filing a bond, fees and allowances, and so on), an annual accounting to the court, obtaining a court order before property can be used for the infant's maintenance, the expense and delay of court approval for the sale or mortgaging of the infant's realty (sometimes urgently needed for the infant's support), restriction of investments to those prescribed by law (sec. 1256), and other similar handicaps to flexible administration. These handicaps are overcome by creating a trust for the infant's benefit.

(b) *Financial safety.* An outright devise or bequest of substantial funds to a widow or other beneficiary frequently exposes them to the importunities of friends and relatives, the danger of ill advised investments, and the natural consequences of business inexperience. A testamentary trust provides a responsible and experienced trustee who may relieve inexperienced beneficiaries of the worries, responsibilities and risks to which they should not be exposed.

(c) *Tax economy.* An outright disposition may entail repeated and successive taxes on subsequent transfers of the same property. Say a decedent leaves 1000 shares of American Telephone & Telegraph Company stock to his widow. An estate tax is payable on that bequest. The widow, on her death, leaves the stock to her son. An estate tax is payable again on the same stock. The son, on his death, leaves two children, each with a bequest of 500 shares of the same stock. Once again an estate tax is payable on the same stock. If the original testator had left the stock in trust, the income payable to his widow for life, then to the son for life, with remainder over to the grandchildren, only the first estate tax would have been payable.

1235. Settlor constituting himself trustee. An express trust may be created without transfer, by a simple declaration by the owner that thenceforth he holds such property in trust for the benefit of some other person or persons named.

Example: The owner of securities agreed to hold them for the account of a correspondent to secure drafts drawn by the owner against the correspondent. *Held*, that such agreement made the owner a trustee in respect to such securities.⁴

⁴ *Sexton v. Kessler*, 172 Fed. 535.

The declaration must not take the form of a voluntary *promise to convey or transfer*, for such promise, as we have seen (sec. 1223), is ineffective without consideration.

1236. Savings bank (*Totten*) trusts. A common illustration of a settlor constituting himself trustee is furnished in the case of "savings bank trusts" (sometimes referred to as *Totten trusts*⁵), where a person deposits his own money in a savings bank for the benefit of another. Savings bank trusts are either *revocable* or *irrevocable*. They are generally held revocable if the settlor retains the passbook; irrevocable, if he transfers it. Upon the depositor's death, the trust becomes irrevocable. The *beneficiary's* death does not affect the depositor's right to revoke the trust, so long as he has not transferred the passbook.

E. Express Trusts: Purposes

1237. In general. Trusts in real property, as stated (sec. 1227), are limited in many states to certain specified purposes. Trusts in personal property may be created for any purpose not contrary to law. Among the more common forms dealt with by lawyers specializing in fiduciary practice are: (a) trusts for married women, (b) family settlement trusts, (c) spendthrift trusts, (d) charitable trusts, (e) insurance trusts, (f) investment trusts, (g) voting trusts (described in section 845), and (h) trusts for the benefit of creditors. Accountants (except those who specialize in the investment field) are most likely to meet with family settlement trusts and trusts for the benefit of creditors. The former are usually set up by will, the administration of which frequently demands the services of an accountant, especially as to inventory and estate tax requirements (secs. 1192 and 1210), together with problems of apportionment between principal and income (secs. 1262-1273). Equally indispensable, frequently, are the services of an accountant in connection with trusts for the benefit of creditors, particularly those relating to assignments for the benefit of creditors and the duties of a trustee in bankruptcy proceedings (secs. 1244 and 1307).

1238. Trusts for married women. Formerly, trusts for married women were devised because of the latter's common law disabilities (sec. 23) and the fear that the husband, who upon

⁵ From *Matter of Totten*, 179 N.Y. 112.

marriage acquired control of his wife's property, might use it for his own benefit. The principal function of a married woman's trust today is to protect her from her husband's influence exercised by persuasion, sympathy or otherwise against her own interests and for the husband's benefit. The trustee stands in the way of such influence.

1239. Family settlement trusts. The most common type of trust is that whereby a person provides for a settlement or distribution of his property to his family through the medium of a trustee empowered to manage trust property, collect and pay out income, and ultimately distribute the principal or "corpus." Although such trusts are usually testamentary, they are sometimes set up by a husband as part of a divorce settlement, by stipulation embodied in the decree. Family settlement trusts, in addition to providing for the support and maintenance of a donor's family, may specify particular purposes for which trust moneys shall be used, as in the case of a trust providing for a daughter's dowry, or the education of children or grandchildren.

1240. Spendthrift trusts. A spendthrift trust, as noted in section 1222, is one created with a view to providing a fund for the maintenance of an improvident person, by securing the fund against his improvidence or incapacity. Such trusts, as a rule, provide for the payment of the income of trust property to the beneficiary, but prohibit him from alienating (selling or assigning) his interest, or anticipating the income (as by borrowing against it), or subjecting it, in advance of payment, to the claims of his creditors. A person may not immunize himself against the claims of creditors by setting up a spendthrift trust for his own benefit, but if he sets up a spendthrift trust for someone else, the court may sustain it, not out of consideration for the beneficiary, but because a donor has a right to control his bounty.⁶ The fund may be effectively placed beyond the reach of creditors by a provision that the

⁶ *Bowlin v. Citizens' Bank & Trust Co.*, 131 Ark. 97, 198 S.W. 288; *Seymour v. McAvoy*, 121 Cal. 438, 53 P. 946; *Kiffner v. Kiffner*, 185 Iowa 1064, 171 N.W. 590; *Sherman v. Havens*, 94 Kan. 654, 146 P. 1030; *Roberts v. Stevens*, 84 Me. 325, 24 A. 873; *Manders v. Mercantile Trust & Deposit Co.*, 147 Md. 448, 128 A. 145; *Morel v. Cornell*, 234 Mass. 563, 125 N.E. 575; *Bixby v. St. Louis Union Trust Co.*, 323 Mo. 1014, 22 S.W. 2d 813; *Lynch v. Lynch*, 161 S.C. 170, 159 S.E. 26; *Eubank v. Moore* (Tex. Civ. App.), 297 S.W. 791; *Bruceton Bank v. Alexander*, 83 W.Va. 573, 98 S.E. 804.

trustees in whom the spendthrift fund is vested may *in their discretion* apply the whole or some portion of the income to the support of the beneficiary. The tendency in some states is to regard spendthrift trusts as contrary to public policy in thwarting the just claims of creditors; but even in those states, such trusts are recognized to a limited extent. In New York, for example, trusts may be created in such a way as to provide that in case of bankruptcy or insolvency the income will cease and be payable to another.⁷

Attachments and garnishments. Although a state may refuse to uphold the validity of a spendthrift trust on grounds of public policy, its statutes may have the effect of upholding such trusts to a limited extent. Thus, New York statutes prohibit the assignment of trust income, and limit attachments and garnishments to the customary 10% applicable to salary income.⁸ In no case may the principal of such trust be subjected to garnishment. (For an illustration, see sec. 1812.)

1241. Charitable trusts. Charitable trusts have two essential characteristics: (a) they are created for an indefinite number of unascertained persons and (b) they have, for their object, some public benevolence. If either of these elements is lacking, the trust is not charitable. Charitable trusts are generally grouped into four classes: (1) religious, (2) educational, (3) eleemosynary, and (4) governmental.

Example of religious trust: A bequest "to the Evangelical Baptist Benevolent and Missionary Society for the benefit of Poor Churches of the City of Boston and Vicinity."

Example of educational trust: A devise in trust for the establishment of a college.

Example of eleemosynary trust: A bequest to a trustee for the use and benefit of the poor widows and children under ten years of age in a given community.

Example of governmental trust: A legacy in trust to the town of New Rochelle for the purpose of erecting a town house for the transaction of town business.

Cy pres doctrine. The term *cy pres* means, literally, "as nearly as possible." When the purpose of a charitable trust becomes impossible of fulfillment in accordance with the donor's intentions, the court may, in exceptional cases, adapt the charity as nearly as possible so as to give approximate effect to the intention of the donor.

Example: A bequest was made in trust for propaganda against Negro

⁷ *Bramball v. Ferris*, 14 N.Y. 41.

⁸ *Personal Property Law*, sec. 15; *Real Property Law*, secs. 98 and 103; *Civil Practice Act*, sec. 684.

slavery. After slavery was abolished, the heirs of the donor claimed the fund. The court, under its *cy pres* power, ruled that the trust fund, if administered for the benefit of the colored race, would approximate the donor's intentions.⁹

1242. Insurance trusts. Trusts are frequently established in the proceeds of a life insurance policy, either by the terms of the policy itself, or by an express declaration of trust, or by an agreement between the assured and a designated beneficiary that the latter shall apply and pay over to a third person part or all of the proceeds.

1243. Investment trusts. Investment trusts are organizations for the collective investment of the funds of numerous individuals in numerous securities. They have taken three forms: (1) the Massachusetts or business trust, holding securities in trust and issuing participation certificates giving the owners equitable interests in the stocks held in trust, (2) corporations which issue stock or debentures and invest the proceeds in widely diversified securities, and (3) corporations which deposit stocks with a trustee and issue certificates of interest in such stocks. With the enactment of statutes requiring investment trusts to incorporate, the last form of investment trust is the most prevalent.

1244. Trusts for the benefit of creditors. Trusts for the benefit of creditors may take various forms:

(a) *Trusts to sell real property* for the benefit of creditors, which are sometimes set up by debtors who are "land poor," though more frequently they are incidental to a general assignment for the benefit of creditors.

(b) *Trust deeds*, which have been described in section 1145.

(c) *Deposit of bonds in reorganization proceedings*, with bondholders' committees who function as trustees in connection with such bonds, for the purpose of achieving united action in respect to a plan of reorganization (sec. 897).

(d) *Statutory trusts* created by Federal or state statute, as in the case of trustees in bankruptcy (sec. 1282).

1245. Escrow deposits. Similar to the duties and responsibilities of a trust are those of an escrow deposit. We have already referred to the distinction between an agent and an escrow holder (sec. 546, subd. (e)). The term *escrow* denotes a conditional delivery to a third party (*escrow holder*, or *depository*) of some instrument or thing of value such as a deed, doc-

⁹ *Jackson v. Phillips*, 14 Allen (Mass.) 539.

ument of title, money or securities, deposited by the *grantor*, or *donor*, for delivery to the other party (*grantee*, or *donee*) upon the happening or fulfillment of the condition, or, in case of nonfulfillment, to be returned to the donor. The escrow holder or depositary is liable to the donor as trustee if he fails to return the escrow deposit on nonperformance of the condition.¹⁰

F. Implied Trusts: Resulting and Constructive

1246. **Nature of implied trusts.** Implied trusts, as already noted (sec. 1220) are those which, without being expressed in words, are inferred from (a) conduct or (b) the nature and circumstances of the transaction. They include *resulting* and *constructive* trusts.

Resulting and constructive trusts distinguished. Resulting trusts are those presumed to exist from the supposed intention of the parties as indicated by their conduct and the nature of the transaction. Constructive trusts, on the other hand, are those which are construed to exist by a court of equity, regardless of the actual or presumed intention of the parties, often, indeed, directly contrary to such intention, so as to defeat the designs of those who, acting in a fiduciary capacity, seek by fraud or otherwise to gain some unfair advantage.

1247. **How resulting trusts may arise.** Resulting trusts may arise in any situation justifying the intervention of a court of equity for the purpose of establishing the rights of the true or equitable owner, where title to the property is legally in the name of a person who is not justly entitled to it.

Examples:

(1) I give you \$10,000 to buy certain property in my name and you buy the property in your own name. Equity will declare that you hold the property as a trustee for my benefit.

(2) I transfer property to you with the mutual understanding that the transfer is in trust; but the understanding is inadequately, imperfectly or illegally expressed, so that it fails as an express trust. Equity will not permit you to benefit from such failure, but will declare you to hold as a resulting trustee.

(3) A trustee or other fiduciary invests trust funds for his personal benefit. As to any profits so derived, he is a resulting trustee.

Effect of resulting trust. A resulting trust is a passive or naked trust (sec. 1223). In consequence, the trustee's function is merely that of obeying a decree of court requiring him to transfer the property in question, with all accruing benefits, to the true beneficial owner. (See sec. 1226.)

¹⁰ *Parker State Bank v. Pennington*, 9 Fed. 2d 966.

1248. Basis of constructive trusts. The basis of a constructive trust is fraud, actual or constructive; hence constructive trusts are sometimes referred to as trusts *ex maleficio*.

Actual fraud consists in deception by direct misrepresentation or concealment. Its elements have already been considered (sec. 126). It may take a thousand forms, too numerous to mention. A simple example is furnished where one obtains a conveyance of land from an illiterate person, by misrepresenting the nature of the transaction. Such fraudulent grantee holds title as constructive trustee for the benefit of the illiterate grantor.

Constructive fraud consists in any act or omission contrary to good faith or good conscience, to the injury of another. It may arise out of the nature of the transaction, as where one person disposes of property to another for a consideration so grossly inadequate as to create the inference of fraud; or it may arise out of a relationship of parties which gives one of them an advantage over the other, or which requires exceptional good faith because of such relationship, as in the case of husband and wife, parent and child, brother and sister, attorney and client, principal and agent, guardian and ward, partner and copartner, executor or administrator and the beneficiaries of an estate.

1249. Statute of frauds inapplicable to resulting and constructive trusts. The statute of frauds applies only to express trusts; that is, to the way in which such trusts shall be expressed. It therefore has no applicability to resulting and constructive trusts, which are created, not by acts of parties, but by operation of law to insure justice.

G. Trustees and Trust Management

1250. Qualification of trustees. A trustee is frequently required to "qualify" for his duties (that is, to become legally empowered to discharge them) by filing a bond and taking a prescribed oath. Such is the case when a trustee is named in a will, or appointed pursuant to a power (sec. 1220) contained in a will, or appointed by a surrogate or probate court when the trustee named in a will dies or renounces the trust, or becomes incompetent, or is otherwise disqualified. A trustee cannot "qualify" unless he possesses the necessary qualifications.

Any person may be a trustee who has legal capacity to make contracts and to do the acts required by the terms of the trust. Hence, even infants, idiots and lunatics may be trustees if their disability does not interfere with their capacity to execute the trust. Some states (New York, for example) provide

that no person may act as a testamentary trustee if he is an infant, an adjudged incompetent, a nonresident alien, a felon or a person incompetent to execute the duties of the trust by reason of drunkenness, dishonesty, improvidence or want of understanding. A corporation may be a trustee when so authorized by its charter, or when the trust is necessarily incidental to its express powers; but an unincorporated association may not act as trustee except in the case of a charitable trust. A person cannot be trustee for himself.

1251. Executors and testamentary trustees: separation of functions. Though the persons named in a will as executor and as trustee are often one and the same, their functions are separate and distinct. The basic function of an executor, as noted in section 1194, is to collect, convert, and distribute with reasonable dispatch. The basic function of a trustee is to administer the trust in accordance with its terms. When the executor's duties are completed, he must make such distribution in trust as the will directs. Occasionally, the duties of executor and trustee merge, in which event single commissions only are allowed (sec. 1261). If the testator creates a trust but names no trustee, or the trustee dies, renounces or is disqualified, the executor must set up a trust fund, retain it in his custody, and attend to such administrative duties in respect to it as may be necessary pending court appointment of a trustee. Frequently an executor, as such, transfers to himself, as trustee, the property and funds devised and bequeathed in trust. In doing this and in all matters affecting his separate duties as executor and as trustee, he must keep separate books of account.

1252. Powers, rights, duties and liabilities of trustees: in general. The powers, rights, duties and liabilities of trustees may be specifically defined in a trust instrument, such as a will, deed or trust agreement. In addition, the law imposes upon trustees the duty to exercise the highest degree of good faith, care and skill—beyond that of an ordinary agent or fiduciary. A trustee is not, however, an insurer; he is required merely to exercise reasonable judgment. He must keep his beneficiary duly informed; must seek advice of counsel when in doubt; and he must avoid placing himself in any position where his personal interest will conflict with the duties of his trust.

1253. Delegation of duties. A trustee is selected for his judgment, discretion and integrity. Duties calling for the exercise of these qualities cannot be delegated, in the absence of specific authority to delegate them. However, when a delegation of functions is obviously necessary, as in a case where it is necessary to call in the services of an attorney, an accountant, or other skilled assistance, a delegation of functions is permissible. Also, a distinction is made between discretionary functions, which a trustee is ordinarily not permitted to delegate, and ministerial, or merely clerical, routine or mechanical functions, such as rent collections, bookkeeping, stenography or general office work. These a trustee is ordinarily not required to perform personally. The extent to which a trustee may delegate the latter type of duties depends upon the nature and extent of the estate. In any event, the trustee, in delegating functions to others, must exercise reasonable care, and for a failure to do so may be liable for consequent loss. Likewise, a trustee who delegates a strictly trust function which he should attend to personally is liable for consequent loss.

Examples:

(1) A trustee appoints an agent to collect rents. The agent had a criminal record, which the trustee could have readily ascertained prior to appointment. The agent absconded with \$1000. The trustee is liable.

(2) A trustee appoints an agent to perform his trust duties. The agent misappropriates \$1000 of the trust funds. The trustee is liable. (See sec. 1816.)

1254. Trustee with conflicting interests. As noted (sec. 1252), the law imposes upon a trustee the duty of exercising the highest degree of good faith¹¹ in the discharge of his duties. He must not accept the trust if it will conflict with other interests, or with his own. In the discharge of his duties, he must avoid situations where his own interests conflict with those of his trust. When such conflicting interests become unavoidable, he must not prefer his own interests to the detriment of the trust.

Mingling individual with trust funds. We have already noted (sec. 1202) that an executor, administrator, guardian or testamentary trustee who commingles estate funds with his own is not only guilty of a misde-

¹¹ Referred to in the cases as *uberrima fides*, or "most abundant good faith."

meanor, but is liable to the estate for any loss or shrinkage while the funds are so commingled. This would be true regardless of the trustee's good faith. (See secs. 1809, subd. (d), and 1817.)

Trustee with personal claim against debtor of estate. "A trustee cannot so manage the trust estate as to obtain the cancellation of his own individual debt, or to secure repayment of advances made by him personally, or to obtain security or satisfaction of his own claim to the detriment of the beneficiary, and where he has a demand due to him personally, and another due to him as trustee, from the same person, and he has obtained satisfaction of the first demand, it is his duty to apply the satisfaction received to both demands, pro rata."¹²

Example: Brown is trustee for Smith. Jones owes him \$1000 personally, and \$3000 as trustee. Jones pays Brown \$1200 without indicating how the money should be applied. Brown must apply at least \$900 of it to the debt due the estate.

Personal transactions with estate. A trustee cannot deal with the estate to his personal advantage. Except for his lawful commissions, he is permitted to derive no profit from his trust, whether by dealing in trust property, selling his own property to the estate, buying estate property (through "dummies" or otherwise) at public or private sale, or lending estate moneys to himself or to members of his family.

1255. Management of trust property: in general. The basic function of a testamentary trustee is to assume custody, invest, manage and distribute. He assumes custody of the trust property, either initially, or upon taking it over from the executor; and if there are any uncollected assets, he collects them, by suit if necessary. The functions of investment, management and distribution, including any power to mortgage, pledge, lease or sell, are governed by the donor's wishes, subject to established rules of law.

Authority to incur and pay debts. A trustee may incur such expenses as are reasonably necessary for the preservation of trust property and the protection of beneficiaries.

Power to mortgage or pledge trust property. A trustee ordinarily has no power to mortgage or pledge trust property unless such authority is conferred by the trust instrument.

Power to lease trust property. "Trustees possess general power to lease trust property on such terms, conditions and rentals as are reasonable and customary for that class of property in the particular vicinity."¹³

1256. Trust investments. The rules of law governing the investment of trust funds and property are designed to afford

¹² 65 *Corpus Juris* 656, citing *Bryant v. Russell*, 23 Pick. (Mass.) 508; *Scott v. Ray*, 18 Pick. (Mass.) 360.

¹³ 65 *Corpus Juris* 791.

maximum protection to beneficiaries on a conservative basis. As a rule, trust moneys may be invested only in a legally prescribed class of securities, commonly designated "legals." As an example, the New York Decedent Estate Law provides that an executor, administrator, trustee or other person holding trust funds may invest them in the same kind of securities as those in which savings banks may invest their deposits.

Where trustee is given discretion as to investments. A trustee authorized to make or continue an investment in securities not prescribed by statute is not liable for losses, provided he exercises fidelity, diligence and prudence.

Example: A will provides: "My said trustee is authorized to hold and possess, or dispose of and convey, any and all of my securities." Among the securities in the estate are 200 shares of Pain Killer stock. The trustee, over a period of years, sold 100 shares of this stock and held the rest, which subsequently shrank greatly in value. The trustee would not be liable for such loss provided he exercised fidelity, diligence and prudence.

Where trustee is instructed to sell and invest proceeds. Where a trustee is instructed to sell property and invest the proceeds, and fails to do so, he may be liable for subsequent shrinkage and loss.

Example: Failure to sell a farm and invest the proceeds, as directed in the will, renders an executor, and the trustee after him, liable for loss of income. (See sec. 1199.)

Lending on mortgage: duty to investigate solvency of mortgagor. When a trustee lends trust funds on mortgage, he must investigate the solvency of the mortgagor as well as the adequacy of the security, because if the mortgaged property depreciates in value, the trustee should be able to fall back on the solvency of the borrower.

1257. Sale of trust property. "In the absence of express or implied authority conferred by the instrument creating the trust, and in the absence of the voluntary assent of all the beneficiaries, a trustee is under no duty to sell and convey the corpus of the trust property and has no power to do so without first obtaining an order of sale from a court of equity, especially where such sale and conveyance would put it out of the power of the trustee to perform the duties imposed upon him by the instrument creating the trust."¹⁴

1258. Distribution of trust property: in general. It is the trustee's duty to distribute trust income and property to those duly entitled thereto under the terms of the trust. This includes not only rents and profits currently collected, but also the principal by way of final distribution. In making such

¹⁴ 65 *Corpus Juris* 730-1.

distribution, a trustee must be careful at all times to distinguish between principal and income. If he has charged expenditures against principal which were properly chargeable to income, or *vice versa*, he may be held to account by the class of beneficiaries thereby prejudiced. Every material act of a trustee is subject to scrutiny and challenge when he renders his accounting as required by law.

H. Accounting and Settlement: Principal and Income

1259. Nature of accounting. We have already referred to the final accounting by an executor or administrator upon the closing of the estate (sec. 1210). The term *accounting*, as a proceeding, is not to be confused with the mere rendering of an account.

Account. The rendering of an account on behalf of an estate is purely informatory. It consists in the preparation and verification of a statement by the fiduciary, in narrative form supplemented by schedules, reflecting his stewardship in the administration of the estate.

Accounting. An accounting is a proceeding. It is *voluntary* when made at the instance of the fiduciary himself, *involuntary* when the fiduciary is compelled by the Court to make it, either at the instance of someone interested in the estate, or by the court of its own motion. In such a proceeding, the fiduciary submits his account for judicial approval. The trustee charges himself with all principal and income received and all gains in respect thereto, and he credits himself with all expenditures on behalf of the estate, with any shrinkage or loss of estate assets, and with all distributions under the trust. (See sec. 1200.)

Objections. The account as thus rendered may be challenged by persons interested, who raise issues in respect to it by filing *objections*. If principal or income has been improperly charged, the Court will direct an adjustment.

Settlement. If the account is found to be correct, it is judicially *settled* by a decree approving the acts of the fiduciary as set forth in the account. A judicial settlement is binding and conclusive upon all parties served with notice of the proposed settlement and as to all matters embraced in the settlement decree.

1260. Intermediate v. final account. An *intermediate* account is one made pending administration. Such an account is filed when the fiduciary continues to hold trust assets, or where a general guardian continues to function during a period of infancy. An intermediate account may be informatory only, or it may be submitted for the purpose of obtaining a judicial settlement for the period covered.

A *final* account is one rendered at the conclusion of the fiduciary's task. The object of such an accounting is always to secure a judicial settlement.

1261. Commissions. A testamentary trustee's commissions are usually fixed by statute. Such commissions are generally based on all sums of principal and interest received and paid out.

Single v. double commissions. When one occupies dual functions under the same instrument, as when the same person is designated in a will both as executor and as trustee, he cannot charge double commissions unless his functions as executor are separate and distinct from those as trustee. For example, if the fiduciary's duties as executor are first completed before his duties as trustee commence, he will be entitled to commissions in each capacity. If, however, his duties as executor and trustee are not severable under the will, double compensation will not be allowed.

Annual rests. The practice of establishing rests, or periodical balanceings of an account for the purpose of converting interest into principal and charging interest thereon, has been referred to in section 1064. Periodic rests may be set up also by informal account as a basis for commissions. (See sec. 1828.)

1262. Principal and income: in general. Trusts frequently provide for income to go to certain persons for life, or for a fixed period embraced by lives in being (sec. 1229), with the remainder, or *corpus* (principal), to go to someone else on completion of the income period. The recipient of the income is commonly referred to as the life tenant or life beneficiary, as distinguished from the remainderman, who is entitled to the principal or *corpus*. The interests of the two frequently conflict. A trustee must carefully distinguish between them.

Generally speaking, the principal or *corpus* of a trust includes property originally coming into the trustee's hands, plus its increase in value, or any new form of investment which such property may take, or any proceeds from the sale of such property, including profits realized on such sale. Income includes any earnings derived from the use and management of trust property, or from a business held in trust. In short, the trust property itself belongs to the remainderman, its yield to the life beneficiary.

Profit or loss. Operating profits or losses are credited or charged, respectively, to income. Profits on the sale of capital assets, or losses or shrinkage in value thereon, are credited or charged, respectively, to principal.

1263. **Interest.** Interest, unlike a prospective dividend, represents a definite accrual of debt regardless of when it is payable.¹⁵ Thus, when a testator dies leaving interest-bearing bonds as part of a trust fund, interest must be apportioned between principal and income. Interest accrued prior to death (which belonged to the testator at death) becomes part of principal. Interest accruing subsequently is income and belongs to the life beneficiary.

1264. **Dividends.** Whether a dividend must be paid to the life beneficiary or credited to principal will depend upon whether it is a *cash*, *stock* or *liquidating* dividend. In the case of a cash dividend,¹⁶ some jurisdictions distinguish between *ordinary* and *extraordinary* dividends, though the majority of states do not. A further determining factor, in allocating a cash dividend to principal or interest, is its *effective date*.

Cash dividends: ordinary v. extraordinary. Whether a trustee must pay a cash dividend to the life beneficiary, or credit it to principal, or apportion it may be prescribed in the trust instrument itself. If not, the decision depends upon the jurisdiction. The so-called Massachusetts Rule, expressing the majority view, makes no distinction between "ordinary" and "extraordinary" dividends, but regards all cash dividends as income. This rule is now embodied in the Uniform Principal and Income Act.¹⁷ A minority of states have adopted the so-called Pennsylvania Rule.¹⁸ That rule makes no distinction between cash and stock dividends, but emphasizes the distinction between "ordinary" and "extraordinary" dividends. As to the latter, it inquires into the period during which the dividend earn-

¹⁵ Except in cases where interest is payable upon a condition, such as the maintenance of a deposit in a savings bank for a minimum period.

¹⁶ The term *cash dividend* is here used in contradistinction to the term *stock dividend*, though it may be payable in value other than cash, such as merchandise (a whiskey dividend, for example), or shares or obligations of corporations other than of the declaring corporation.

¹⁷ Adopted in Alabama, California, Connecticut, Florida, Illinois, Louisiana, Maryland, North Carolina, Oklahoma, Oregon, Pennsylvania, Utah and Virginia. Among the states which have followed the Massachusetts Rule, without having adopted the Uniform Principal and Income Act, are Maine, Massachusetts and Ohio.

¹⁸ Although this rule was originally formulated in Pennsylvania, that state abandoned the rule in 1945 when it adopted the Uniform Principal and Income Act. Other states which have followed the Pennsylvania Rule are Minnesota, Mississippi, New Hampshire and Wisconsin. Besides Pennsylvania, other states which formerly followed the Pennsylvania Rule are California, which adopted the Uniform Principal and Income Act in 1941, and New York, which (as to stock dividends only) has adopted a provision similar to that embodied in the Uniform Principal and Income Act, namely, that stock dividends, regardless of when earned, shall constitute principal. (See following, this section, *Stock dividends*.)

ings were accumulated. If the entire dividend was earned *before* the commencement of the life interest, the whole of it is allocated to principal. If the entire dividend was earned *after* the commencement and during the continuance of the life interest, the whole of it is awarded to income. If the dividend was earned partly before and partly after commencement of the life interest, the dividend (cash or stock) is apportioned between the life tenant and the remainderman. In distinguishing between ordinary and extraordinary dividends, the following tests are applied: (1) whether similar dividends have been declared with regularity in the past, (2) whether such dividends are regularly paid out of current earnings, (3) the frequency with which such dividends are declared, (4) the size of the dividend in relation to the market value of the shares at the time of the creation of the trust, (5) the designation, if any, placed upon it by the directors of the corporation, and (6) the source of the earnings from which the distribution is made.¹⁹

Effective dividend date. When a cash dividend is declared but not paid during the lifetime of a testator, a trustee may have to decide whether to allocate such dividend to principal or to income. The rule applicable has not been uniform, some states holding that the effective date is the date of declaration, others that the record date controls. The present tendency²⁰ is toward the latter rule, which may be regarded as the majority rule.

Example: A owns 100 shares of stock. At a meeting held on January 10, 1948, the board of directors declared a dividend payable on April 1, 1948, to stockholders of record March 1, 1948. A dies on February 15, 1948, leaving his property in trust to his wife for life, remainder to his son. In jurisdictions where the declaration date (January 10, 1948) controls, A would have been entitled to the dividend prior to his death, hence the dividend would be principal. In jurisdictions where the record date (March 1, 1948) controls, A, during his lifetime, would not have been entitled to such dividend; hence the dividend would be treated as income instead of principal.

Stock dividends. The Uniform Principal and Income Act,²¹ reflecting the Massachusetts Rule, provides that "All dividends on shares of a corporation forming a part of the principal which are payable in the shares of the corporation shall be deemed principal." The tendency is to drop the old rule that a stock dividend would be treated as principal or income, respectively, according to whether it came out of surplus existing before the trust was created or was earned afterwards.²²

¹⁹ These are the tests as given in the *Restatement of the Law of Trusts*, Vol. 1, p. 703.

²⁰ As pointing the trend, the New York Legislature, by Chapter 239 of the Laws of 1946, abandoned the declaration date in favor of the record date.

²¹ Sec. 5 (1).

²² This, for example, was the rule in New York, expressed in *Matter of Osborne*, 209 N.Y. 450, until superseded by statute (*Personal Property Law*, sec. 17-a). The statute specifically provides that the addition of such stock dividends to the principal of a trust shall not be deemed to violate the Rule Against Accumulations (sec. 1230).

Liquidation dividends. The modern rule governing liquidation dividends (sec. 848) is expressed in the Uniform Principal and Income Act²³ as follows: "Where the assets of a corporation are liquidated, amounts paid upon corporate shares as cash dividends declared before such liquidation occurred or as arrears of preferred or guaranteed dividends shall be deemed income; all other amounts paid upon corporate shares on disbursement of the corporate assets to the stockholders shall be deemed principal. All disbursements of corporate assets, whenever made, which are designated by the corporation as a return of capital or division of corporate property shall be deemed principal."

1265. Stock rights. The rule prevailing in a majority of the states is reflected in the Uniform Principal and Income Act, which provides²⁴ that "All rights to subscribe to the shares or other securities or obligations of a corporation accruing on account of the ownership of shares or other securities in such corporation, and the proceeds of any sale of such rights, shall be deemed principal." The minority or Pennsylvania Rule apportions "intact value" to principal and the rest to income²⁵; "intact value" being regarded as the book value at the time when the trust came into existence, or the purchase price if the stock was purchased later.

Example: A testamentary trustee buys 400 shares of stock²⁶ (par value, \$100) at 120. Subsequently, he receives 400 rights, entitling him to subscribe to 100 additional shares at 100.

(a) If the trustee exercised his rights and later sold forty shares at 130, the proceeds, under the majority rule, would be deemed principal. Under the minority rule, so much of the profit as would be necessary to maintain the "intact value" of the stock would be deemed principal, the rest income. Thus, the "intact value" of the stock ($400 \times \$120$ plus $100 \times \$100$) is \$58,000, or \$116 per share. The "intact value" of the forty shares ($40 \times \$116 = \$4,640$) would be deemed principal, and the difference ($40 \times \$14 = \560) would constitute income.

(b) If the trustee did not exercise his rights but sold them at \$4.50 each, the proceeds, by a fairly uniform rule, would be treated as principal, on the theory that the value of the rights roughly approximates the difference in value of the stock before and after issuance.

1266. Income earned during administration period. Statutes generally prescribe a period of administration during which the executor is required to withhold payment of legacies pending

²³ Sec. 5 (3).

²⁴ Sec. 5 (2).

²⁵ *In re Waterhouse's Estate*, 308 Pa. 422, 162 Atl. 295.

²⁶ Any purchase of securities by a trustee other than "legals" would of course have to be authorized by the trust instrument (sec. 1256).

prior payment of debts. The usual period is one year, though it may be shorter in some states.²⁷ The disposition of income earned during this period (unless otherwise directed in the will) depends on the character of the bequests. Specific legacies (for example, bequests of stocks and bonds) carry income from the date of the testator's death. Interest on general legacies (sec. 1208) is not payable until the close of the administration period. In the case of beneficiaries under a trust created out of a residuary estate, the statute may provide that such beneficiaries shall receive the income earned during the administration period, from the date of the testator's death. (See sec. 1819.)

1267. Bonds purchased above or below par. Bonds purchased at a premium grow less valuable as they approach maturity. Bonds purchased at a discount grow more valuable as they approach due date. In dealing with bonds purchased at a premium, a trustee is frequently confronted with the question of whether the diminishing premium is chargeable to principal, or whether he must amortize it out of interest payments so that when the bonds are redeemed, the principal will remain at the original amount for which they were purchased. In dealing with bonds purchased at a discount, the trustee is likewise confronted with the question of whether the benefit of the discount is to go to the life beneficiary when the bonds are redeemed, or whether the accumulated discount belongs to the *corpus* and is to be credited to principal. These questions may be resolved by the testator himself. In the absence of direction from the testator, the trustee must be guided by the applicable rules of law.

Bonds purchased at premium by testator. A testator's investments are valued as at his death. Hence a trustee is not required to amortize the premium on bonds bought by the testator; the interest on the bonds, without deduction, goes to the life beneficiary.

Bonds purchased at premium by trustee. Bonds purchased by the trustee at a premium during the administration of the estate represent a fixed outlay of principal at the premium price. By the rule prevailing in a majority of states, the trustee must amortize the premium. The practice is to set up a sinking fund out of deductions from interest payments, so that when the bonds are redeemed at par, the trustee will have an addi-

²⁷ In New York, for example, the period is seven months without publication of notice to creditors, six months where notice is published. (See sec. 1204.)

tional sum set aside which, with the face amount of the bonds, will equal the original outlay of principal.

Bonds purchased at discount. In the majority of jurisdictions, the logic of the rule that on bond redemption at maturity the amount in the trustee's hands should equal the valuation at death (in case of purchase by the testator) or the outlay of principal (in case of purchase by the trustee) is not applied in the case of bonds purchased at discount. The life beneficiary in such cases receives only the interest on the bonds, and upon maturity, the accumulated discount falls into principal.

Premium and discount bonds: Uniform Principal and Income Act. Somewhat more consistent than the prevailing rule governing premium and discount bonds is the pertinent provision of the Uniform Principal and Income Act²⁸: "Where any part of the principal consists of bonds or other obligations for the payment of money, they shall be deemed principal at their inventory value or in default thereof at their market value at the time the principal was established, or at their cost where purchased later, regardless of their par or maturity value; and upon their respective maturities or upon their sale any loss or gain realized thereon shall fall upon or enure to principal." The effect of such a provision is to relieve the income beneficiary of deductions for premium amortization while leaving undisturbed the benefit to principal of discount accumulation on bonds purchased below par.²⁹

1268. Sale of securities. Profits on the sale of capital assets, as noted (sec. 1262), are credited to principal. This, of course, would include securities in the trust estate. "Where stock, bonds, or other property belonging to the trust estate are sold, the money received, including profits, if any, ordinarily constitutes a part of the corpus of the estate. . . ." ³⁰

1269. Charges against principal and income; in general. The nature and purpose of a trust expenditure determine whether it should be charged to principal or income. The ordinary expense of administering and preserving a trust is generally chargeable to income, in the absence of contrary instructions

²⁸ Section 6. See note 17 on page 632, showing states which have adopted the Act. New York has adopted an amendment substantially identical with sec. 6 of the Act.

²⁹ The purpose of the codification was stated in part as follows in the note of the New York State Law Revision Commission when the New York statute was amended in 1942 (Personal Property Law, sec. 17-d): "This amendment codifies the existing law with regard to discounts, but relieves the income beneficiary from hardship by abolishing the requirements of amortization of premiums unless such amortization is required by the terms of the trust." (It should be noted that New York is one of the states which have adopted portions of the Uniform Principal and Interest Act without having adopted the uniform statute *in toto*.)

³⁰ 65 *Corpus Juris* 859.

from the donor or the court. Unusual and extraordinary expenses which go to enhancing the principal are chargeable to principal, not income. Expenditures for the benefit of both principal and income must be apportioned to both to the extent of such benefit.

1270. Improvements and repairs. The general rule is that improvements and repairs of a permanent nature are chargeable against principal, while ordinary repairs and improvements are chargeable against income.³¹ Thus, even minor repairs are held chargeable to principal if made to put premises in tenantable condition. This is on the theory that such repairs are of a permanent nature. (See sec. 1806.) On the other hand, repairs of a current operating nature are clearly chargeable against income as operating expense. When the improvements benefit both principal and income, they are apportionable.

Example: An old dwelling is reconverted into a modern apartment house by interior reconstruction, installation of elevators, new lighting and plumbing fixtures, and so on. The house is now worth more, hence a substantial part of the cost of repairs and improvements should be charged against principal. But the house earns more, too; hence part of the cost should be charged against income.

1271. Carrying charges. A life tenant of realty, as we have noted (sec. 1027), having the benefit of current use, is chargeable with current maintenance, including carrying charges, such as mortgage interest, taxes, insurance, and so on. On the same principle, the life beneficiary of a trust is similarly chargeable. Assessments, however, being generally levied for permanent improvements which benefit the premises currently, also, are generally apportioned between principal and income. Carrying charges on nonproductive property are borne by the remainderman, there being no income against which it can be charged.

1272. Wasting assets. Assets with a limited life are referred to as *wasting assets*. Examples are leaseholds, patent rights, copyrights, mines, oil wells, timberlands, licenses, and any contracts, generally, which create rights for a limited period. Income on such assets, in the form of rents, royalties, and so on, eats away principal to the extent that it shortens the income-producing life of the asset. To make up for this erosion of

³¹ 65 *Corpus Juris* 714.

principal, the trustee is required to retain a portion of the income on such assets sufficient to replace them, or their value, upon their becoming completely exhausted.

1273. Administration and management: fees, commissions and expenses. The basic principle governing allocation of fees, commissions and expenses incurred during the course of the administration and management of a trust estate is that charges are borne by the life beneficiary, the remainderman, or both, depending upon whether the cost has been incurred for the benefit of one or the other, or both.

Cost of creating or continuing trust. Before a testamentary trust can be set up, the will has to be probated and the estate administered by the executor. All administration expenses in this connection, including funeral, probate and tax proceeding expenses, legal expenses in connection therewith, and in the collection of estate assets, are essential in laying the foundation for setting up the trust; hence they are chargeable against principal.³² So, also, any expenses in continuing the trust (where, for example, a new setup is necessitated by contingencies provided for in the trust, or where the trustee dies, resigns or becomes disqualified) are properly chargeable against principal.

Management. So much of administration expense as relates to current management for the benefit of the life beneficiary, as opposed to preservation or enhancement of the principal, is chargeable against income. This includes recurrent management expenses, such as (1) the annual premium on the trustee's bond, (2) the expenses of an annual accounting, (3) rental of safe deposit box, and (4) legal, accounting and other fees in connection with current management.

Final accounting. The expense on a final accounting, as distinguished from an annual accounting, is chargeable to principal.

Legal expenses. All legal expenses in connection with the preliminary administration of the executor are, as stated, chargeable to principal. Legal expenses in construing a trust provision, if incurred by authority of the trustee on behalf of the estate, are chargeable to principal; if incurred on behalf of a life beneficiary in opposition to the trustee, or in a contest with the remainderman, they are chargeable to such life beneficiary unless the probate court otherwise directs.

Commissions. The trustee's commissions, being based on all sums of principal and income received and paid out (sec. 1261), are allocated to principal and income accordingly.

1274. Invasion of principal. Testators are sometimes well advised to incorporate a provision in the will, authorizing the trustee, in his discretion, to "invade the principal" for the pur-

³² Except where the testator provides otherwise.

pose of supplying a possible deficiency of income. Interest rates, in the unforeseeable future, may decline almost to the vanishing point; income-producing property may lose its yield; and a widow or infant for whom a testator may have thought he had generously provided, may find herself or himself in actual need while the trustee conserves a frozen principal. The power to invade the principal in such cases, to be exercised only when necessary, rescues the beneficiaries from their plight.

1275. How trusts may be terminated. Trusts, in general, including living as well as testamentary trusts, may be terminated (a) by fulfillment, (b) by merger, and (c) by failure of purpose.

(a) *Fulfillment.* A trust ceases when its terms are fulfilled and there is no further reason for its continuance.

(b) *Merger.* When the legal and equitable interests under a trust become vested in the same person, the equitable interest merges into the legal and the trust ceases. For example, if a brother is designated as a trustee for the benefit of himself and his sister, or the survivor of the two, and the sister dies, both legal and beneficial interests under the trust become merged, the trust ceases, and the brother becomes sole owner without any further need for a trustee.

(c) *Failure of purpose.* When the purpose of a trust fails or becomes impossible of fulfillment, and the *cy pres* doctrine (sec. 1241) cannot be invoked, the trust ceases and the estate passes to the persons who would otherwise have been entitled but for the trust.

1276. Removal of trustee. A court of equity has inherent jurisdiction over trusts. This includes jurisdiction in all actions to declare or establish a trust, and likewise the right to supervise, regulate and control the proper discharge of the duties of a trust, as well as the power to remove the trustee for cause. Among the causes for the removal of a trustee are: (a) adverse personal interest of the trustee which may conflict with his duties or with the interests of beneficiaries; (b) personal unfitness because of incompetence, ill health, intemperance, mental infirmity, old age, dishonesty or improvidence; (c) misconduct and mismanagement; (d) abandonment or neglect of trust; (e) disobedience of court orders or of instructions in a trust instrument; (f) unexcused failure to pay principal or income to beneficiaries; (g) making illegal and unsafe investments, or investments in direct violation of the trust instrument; (h) taking a personal profit; and (i) failure to keep proper accounts or neglecting or refusing to file accounts.

1277. Resignation and discharge of trustee. A trustee, after accepting office, cannot discharge himself from liability by a mere resignation and abandonment of his trusteeship. His resignation must be tendered for cause, or upon the termination of the trust, and it must be duly accepted and approved by the Court or by general consent of all persons interested. However, when a trustee acts without compensation, or without agreement as to time, he may resign as a matter of personal convenience; otherwise, he must have a good reason for resigning. The following grounds have been held sufficient to justify resignation and to warrant discharge of the trustee: completion of the trust; change in nature or extent of trust property; conflict of individual interest with duty as trustee; disagreements among cotrustees, or between trustee and beneficiary, preventing friendly co-operation; failing health or old age of the trustee; misconduct of beneficiaries involving the trustee in difficulties; removal of a trustee from the country; and want of confidence in a cotrustee.³³

Questions and Problems for Review

1. What is a trust? What is the distinction between a legal estate and an equitable estate? How are trusts created? *NY Jan. 1926 (12)*

2. Enumerate the purposes for which express trusts of real property may be created. *NY Oct. 1933 (6)*

3. What is meant by placing a document, or fund, in escrow? What is the effect of such an act? *NY Jan. 1925 (1)*; *NY Jan. 1920 (12)*; *NY Jan. 1919 (5)*

4. *A* died, leaving a will appointing *B* as executor and *C* as trustee of his estate. The will directed the executor to convert the estate into money and, after paying just debts, funeral charges and expenses of administration, to pay over the balance to the trustee. The will directed the trustee to invest the money so received in safe and productive property.

Acting as executor, *B* transferred to *C* a farm valued at \$6000. The trustee retained title to the farm for several years, during which time he leased it at a rental that was not sufficient to pay the taxes and other carrying charges of the farm.

On the death of John Doe, sole beneficiary of the trust fund, his executrix brought suit against the trustee, charging, among other things, that his retention of the farm deprived the beneficiary dur-

³³ 65 *Corpus Juris* 613.

ing his lifetime of the income on \$6000. Is the trustee liable? *NY May 1925 (1)*

5. John Doe is appointed trustee for the management of a large property. Has he the right to delegate his trust duties to an agent? Give reasons, also stating exceptions thereto, if there are any. *NY Jan. 1918 (12)*

6. Andrews was appointed trustee of certain real property by a written instrument which specified that the income was to be paid to a named beneficiary during the latter's life and that title to the property was to be conveyed to another beneficiary upon the death of the life tenant. What duties, if any, may Andrews delegate to assistants or agents? *AI Nov. 1934 (2)*

7. Jones owes Brown \$1000, and Jones owes Brown in the latter's capacity as trustee for Smith, \$3000. Jones pays Brown \$1200 with no indication as to how the money shall be applied. How must Brown apply the \$1200? Why? *NY Oct. 1933 (11)*

8. Is the legal liability of a trustee in the case of a loss any greater when the trust funds are not kept separately, than if they are kept in a separate deposit, it being admitted that the trustee acted in good faith? Explain. *NY Jan. 1924 (11); NY June 1919 (1)*

9. Hardin was trustee of a large apartment house and was directed as such trustee, under the will of the deceased owner, to pay the income and profits from such property to Hobley during his lifetime, and on Hobley's death to deed the same to James. State whether the taxes on such property, the payment of interest on mortgages and the expenses for the necessary repairs on the property should be charged by such trustee against the income of the life tenant or whether they should be charged against the interest of the remainderman. *NY May 1926 (13)*

10. Hopkins by his will made certain gifts and left the rest, residue and remainder of his estate in trust, the income to be paid to his widow during her life and the trust fund to be turned over to his son upon her death. Hopkins left income-producing assets of \$500,000. Legacies of \$300,000 were given by the will and debts; taxes and administration expenses amounted to \$100,000. Assume that administration of the estate required one year, that all the payments for legacies, debts, taxes and administration expenses were made at the end of that year, and that income during administration amounted to \$25,000. In your opinion as accountant for the trustee, to whom should this \$25,000 be given? *AI May 1931 (10)*

11. What are the rules of law governing executors, administrators or testamentary trustees in the investment of trust funds? *NY Apr. 1933 (9)*

12. A wealthy merchant died possessed of a large estate, includ-

ing a variety of industrial securities. In his will he nominated the Uptown Trust Company as executor and trustee. His will contained the following provision: "My said trustee is authorized to hold and possess, or dispose of and convey, any or all of my said securities by proper instruments or conveyances, as in his judgment may be deemed advisable and to collect the principal of the securities and reinvest the same from time to time."

Among the properties coming into the trustee's possession were 200 shares of John Mooney's Pain Killer Manufacturing Company. In the years 1890 to 1895, this stock was selling for \$400 a share, paying 10% net yearly. The trustee at this time sold 100 shares of stock at \$400 per share, retaining the other 100 shares. In 1898, owing to infringement suits against the Mooney Pain Killer Manufacturing Company, the value of the stock had dropped to \$100 a share, paying a dividend of less than 1½%.

Upon filing this accounting, the fact developed that the trustee still held 100 shares of this stock, and the beneficiaries brought suit against the trustee for the shrinkage in value, alleging that the whole 200 shares should have been sold at the higher price. Is the trustee liable to the estate for the apparent shrinkage referred to? *NY Jan. 1924 (2)*

13. When a trustee loans estate funds on a real estate mortgage as security, is he under any obligations to investigate the solvency of the mortgagor? *NY June 1923 (13)*

14. B, a trustee, invests funds of the trust estate in bonds purchased at a premium. Should all of the interest received from such bonds be paid to the life beneficiary? Explain fully. *NY Jan. 1926 (6)*

15. Under the terms of a will, a trustee is required to invest funds of the estate and to apply the income thereof to the use of a beneficiary for life; does the profit on a sale of securities, held as investment under this provision, become income or corpus? *NY May 1925 (8); NY June 1921 (15)*

16. Richard Roe, as the executor and trustee of an estate, holds capital stock in various railroads. One of the roads determines to increase its capital stock and notifies the stockholders of record on what terms they may subscribe for the new stock. The trustee decides not to subscribe and sells his right for \$100. Does this \$100 constitute income or principal? *NY Jan. 1921 (14)*

17. A life tenant and a remainderman are interested in a certain estate. There is a holding of shares in a corporation, which votes to increase its capital. The fiduciary sells the right to subscribe. Do the proceeds belong to the life tenant or to the remainderman? *NY June 1918 (6)*

18. A testamentary trustee duly made an authorized purchase of 400 shares of capital stock (of the par value of \$100 each) at 120.

Subsequently he received 400 rights entitling him to subscribe to 100 additional shares at 100. Entirely regardless of taxable income, how should the trustee render account, distinguishing between principal and income of the trust, in each of the following cases:

(a) The trustee exercised his rights and later sold forty shares at 130.

(b) The trustee did not exercise his rights but sold all the rights at \$4.50 each. *AI Nov. 1931 (11)*

19. As between life tenant and remainderman, is a dividend declared but not paid during the lifetime of a testator to be treated as capital or income? Give reasons. *NY June 1932 (13)*

20. A owns 100 shares of stock of the X Steel Corporation. At a meeting of the board of directors held in January, 1929, a dividend was declared, payable April 1, 1929, to stockholders of record March 1, 1929. A died on March 15, 1929, leaving a will under which everything that he owned at the time of his death was left in trust, the income thereof only to be paid to his wife during her life. When the dividend was paid to the executors on April 1, 1929, was it proper to treat it as part of the trust estate or as income payable to the wife? *AI May 1930 (12)*

CHAPTER XVI

Bankruptcy

1278. Scope of chapter. In this final chapter we consider the nature and purpose of bankruptcy; the distinction between voluntary and involuntary bankruptcy; the persons who may file voluntary and involuntary petitions; the persons against whom involuntary petitions may be filed and the proceedings upon such petitions; acts of bankruptcy; the custody and administration of a bankrupt estate, including receiverships, meetings of creditors, and the election, duties and functions of a trustee; the rights, duties and liabilities of a bankrupt; rights of creditors, including proof, allowance and payment of claims; the discharge of a bankrupt; bankruptcy offenses and the punishments therefor; and the provisions of the Bankruptcy Act of 1938 relating to corporate reorganizations and "arrangement" proceedings.

A. Nature and Purpose of Bankruptcy

1279. Origin and development of bankruptcy laws. Ancient Roman law treated insolvency as a crime, punishable by imprisonment, servitude and even death. The *debtor's gaol*, until comparatively recent times, was an established institution. In 18th century England, Parliament offered escape from the debtor's prison upon the surrender of one's assets for the benefit of one's creditors; but the debtor was not discharged as to any deficiency. Gradually, imprisonment for debt was abolished. The legal principle developed that if one surrendered all his worldly goods, he ought to be relieved of *all* his debts. By the time the United States Constitution was adopted, a number of state statutes not only permitted, but *compelled* an insolvent debtor to surrender his assets for the benefit of his creditors. The United States Constitution took all bankruptcy jurisdiction away from the states: first, by prohibiting any state from passing laws impairing the obligation of con-

tracts; second, by vesting all bankruptcy jurisdiction in Congress, which was empowered to pass "uniform laws on the subject of bankruptcies throughout the United States." Congress has passed numerous bankruptcy laws, including revisions and amendments. The latest became effective September 22, 1938.

1280. Purpose of National Bankruptcy Act. The essential purpose of the National Bankruptcy Act is two-fold: (1) to give honest but insolvent debtors an opportunity to make a new start in life, and (2) to give all creditors an equal opportunity to share in the debtor's property in proportion to their claims. The recent trend is to broaden the first of these purposes. For example, the Bankruptcy Act of 1938 added liberal provisions whereby honest but unfortunate debtors may make "arrangements" to secure financial respite without incurring the taint of bankruptcy.

1281. Bankruptcy and insolvency distinguished. Bankruptcy is a legal status. A person is not a bankrupt unless he has been so declared ("adjudicated") in a bankruptcy court. Insolvency, on the other hand, is a financial status. It has two meanings:

Insolvency in the state or equity sense. Insolvency in the state or equity sense of the term means inability to meet one's debts as they mature. One may be "worth" a million dollars in frozen assets, yet be insolvent in the equity sense because of inability to meet a \$100,000 note when it falls due (sec. 1831).

Insolvency in the bankruptcy sense. Under the Bankruptcy Act a person is insolvent if the aggregate value of his assets is not at a fair valuation sufficient to pay his debts. Thus, if one's entire assets, liquid or otherwise, are worth \$90,000 at a fair valuation, and his liabilities amount to \$100,000, he is insolvent in the bankruptcy sense of the term.¹

Insolvency laws v. bankruptcy laws. There are numerous insolvency laws, but there is only one Bankruptcy Act. (See sec. 1279.) The essence of a bankruptcy law is to compel a debtor to surrender his assets for the benefit of his creditors and to afford him a discharge at the end of a court proceeding if he has fully complied with the law. State laws may compel a debtor to surrender assets in individual cases, either upon an attachment or in execution of a judgment (sec. 73), but they may not compel a debtor to make an involuntary surrender of all his assets for the general benefit of all his creditors; neither may they grant a debtor a statutory discharge

¹By the Bankruptcy Act of 1938, however, the definition of insolvency in the state or equity sense is also recognized: first, under the section which specifies, as an additional act of bankruptcy, the appointment of a receiver or trustee owing to a debtor's inability to pay his debts when due (sec. 1295) and second, in connection with "arrangements" (sec. 1354).

from all his debts. These are bankruptcy functions which the United States Constitution vests exclusively in the Federal courts. State insolvency laws do regulate fraudulent transfers and assignments, and they permit a debtor to make a voluntary general assignment for the benefit of his creditors, or to have a receiver or trustee take charge of his property. The latter two acts, however, constitute acts of bankruptcy (secs. 1295 and 1296), and creditors may force a debtor into bankruptcy on account of them.

1282. Bankruptcy courts: judges and referees. As stated, the Federal courts have exclusive bankruptcy jurisdiction. Original jurisdiction (sec. 74) is in the United States District Court, consisting of judges and referees.

The judge. The United States District Court judge has full authority in matters of original jurisdiction, including not only those brought up directly before the judge but matters on appeal from the referee in bankruptcy.

The referee: appointment. Referees in bankruptcy are appointed for a term of two years by the judge of the United States District Court. The referee is both a judicial and administrative officer.

The referee: judicial functions. Bankruptcy proceedings, especially corporate reorganizations and arrangements, are frequently detailed and complicated. The judge may refer any proceeding to the referee, either before or after adjudication. On a general reference, the referee has complete jurisdiction of the proceedings. He may adjudicate or dismiss the petition (sec. 1283), grant, deny or revoke a discharge, and confirm, refuse to confirm, or set aside an arrangement. He may not commit for contempt, but he may certify to a judge acts which constitute contempt in proceedings before him, and for such acts the judge may punish for contempt.

The referee: administrative duties. A referee's duties are not only judicial but administrative as well. Among the administrative duties of a referee are:

(1) To examine all schedules of property and lists of creditors filed by bankrupts and cause corrections and amendments thereto.

(2) To furnish information concerning bankrupt estates to all parties in interest.

(3) To give notices to creditors.

(4) To make up records embodying facts, and so on.

(5) To conduct hearings.

(6) To keep and transmit to the clerks the records of all proceedings involving the administration of bankrupt estates.

(7) To declare dividends.

The trustee. Laymen sometimes confuse the offices, powers and duties of a referee with those of a trustee. Although both referees and trustees are officers of the Court, a referee functions primarily as the Court itself, whereas a trustee functions primarily on behalf of the creditors. The functions and duties of a referee are both judicial and administrative; those

of a trustee are purely administrative, the trustee being really the representative of the creditors. The trustee's duties are more fully discussed in sections 1307-1312.

Receivers and marshals. In exceptional cases, it may be necessary to entrust the property of a bankrupt to a receiver or marshal for purposes of custody and safekeeping, pending a determination by the Court as to whether a petition should be dismissed or an adjudication ordered, and in the latter case, until a trustee can be elected. The duties of receivers and marshals are discussed in section 1307.

B. Petitions in Bankruptcy

1283. Voluntary and involuntary petitions: in general. Bankruptcy proceedings are commenced by the filing of a petition, asking that the Court declare or adjudge some person a bankrupt. In *voluntary* bankruptcy the petitioner asks that he himself be adjudged a bankrupt. When the proceedings are *involuntary*, the petitioner requests that some person other than the petitioner or petitioners be adjudged a bankrupt.

1284. Voluntary petitions: who may file. Any person (except a municipal, railroad, insurance or banking corporation or a building and loan association) may file a voluntary petition in bankruptcy. The act does not require a voluntary petitioner to be insolvent, or to owe any fixed minimum of debt; there is nothing to prevent a solvent person from having his property distributed among his creditors in bankruptcy.

Example: A corporation has assets convertible into cash amounting to \$285,000. It has outstanding: \$100,000 of common stock; \$50,000 of preferred stock; \$75,000 in bonds; \$8000 in taxes; and \$150,000 in claims of general creditors. Although the corporation is solvent, having \$285,000 in assets as against debts of \$233,000 (outstanding stock is not a debt), it may file a voluntary petition and have its property distributed in bankruptcy. The surplus, after administration expenses, would presumably go to the preferred stockholders (sec. 777). If anything is left, it will go to the common stockholders, *pro rata*.

1285. Involuntary petitions: who may file. When a person is insolvent and refuses to make an assignment for the benefit of creditors or to take any other action, creditors may bring about a distribution of his assets by filing an involuntary petition in bankruptcy against him. Three or more creditors who have provable claims against any person amounting in the aggregate (in excess of the value of any security held by them) to \$500 or over, may file an involuntary petition. If the com-

bined number of creditors is less than twelve, any *one* of such creditors whose claim equals \$500 net, in excess of securities, may file the petition.

1286. Involuntary petitions: against whom may be filed. Any natural person (except a wage earner² or farmer) and any moneyed, business or commercial corporation (except a building and loan association, or a municipal, railroad, insurance or banking corporation) owing debts to the amount of \$1000 or over,³ may be forced into involuntary bankruptcy upon committing an act or acts of bankruptcy (sec. 1291). If a petition is filed against any person or corporation other than those specified, it will be dismissed; for example, a petition against a railroad corporation.

Decedent estates. Creditors cannot force a decedent's estate into bankruptcy. (See sec. 1209.)

1287. Petitions by and against partnerships. The Bankruptcy Act treats a partnership as an entity (sec. 725) separate from the partners. An involuntary petition may be filed against the partnership entity alone, or against it and any of the general partners. The petition may be filed either before or after dissolution of the firm but not after a final settlement of partnership affairs. A trustee in bankruptcy may demand a statement of the individual assets of the partners, outside of their firm assets, even though no petition has been filed against the individual partners; and a trustee must keep separate accounts of partnership property and of the individual property of partners.

1288. Where and how petitions are filed. Petitions are filed in the office of the Clerk of the United States District Court. If the petition is voluntary, it must be accompanied by a schedule of the petitioner's property showing the amount and kind of property, location, value, list of creditors, and their residences, amounts due each, and so on. The petition, whether voluntary or involuntary, must be under oath.

1289. Proceedings upon voluntary petition. In voluntary proceedings the bankrupt merely files a petition, accompanied by schedules of his assets and liabilities, and asks for a dis-

² The Bankruptcy Act defines a wage earner as one "who works for wages, salary or hire, at a compensation not exceeding \$1,500 per year."

³ Preferential payments by a bankrupt are included in computing the \$1000 minimum.

charge. In these schedules he lists all his assets in detail, and all his liabilities, actual or contingent. These schedules are under oath, and are executed in triplicate. The three copies are filed in the office of the District Court where the bankrupt lives or has his place of business. Immediately upon filing a voluntary petition, the petitioner is adjudicated a bankrupt. The procedure subsequent to this is the same as in the case of involuntary proceedings after adjudication.

1290. Proceedings upon involuntary petition. In the case of an involuntary proceeding, three or more creditors, or one creditor, as the case may be (sec. 1285), file a petition setting forth that within the preceding four months the alleged bankrupt has committed one or more of the acts of bankruptcy (secs. 1292-1297). The alleged bankrupt is served with a "writ of subpoena," which is the equivalent of a summons (sec. 73). Such service is returnable within ten days. The alleged bankrupt has five days after the return day within which to answer or plead under oath to the petition. If he fails to answer and the petition is in proper form, he is adjudged a bankrupt. If he denies the allegations of the petition, a trial must be had on the issues. The alleged bankrupt may demand a jury trial when solvency is an issue. If, at the trial, the allegations of the petition are sustained, the debtor is declared or "adjudged" a bankrupt; otherwise, the petition is dismissed.

C. Acts of Bankruptcy

1291. In general. Insolvency alone is no ground for bankruptcy. To be adjudicated a bankrupt, one must have done something that constitutes an act of bankruptcy, and he must have done it within four months prior to the filing of the petition. The Bankruptcy Act lists six acts of bankruptcy (secs. 1292-1297).

1292. First act of bankruptcy: fraudulent transfers. If a person transfers or conceals any part of his property, or permits it to be transferred or concealed, with intent to "hinder, delay or defraud his creditors," he commits an act of bankruptcy. Solvency (Bankruptcy Act definition) is a complete defense to this act.

Examples:

(1) An insolvent debtor ran away with his assets to avoid criminal

prosecution. This was a clear case of concealing assets with intent to hinder, delay and defraud creditors.⁴

(2) An insolvent debtor raised money to pay certain particular creditors by executing and delivering, to a security trust company, a chattel mortgage covering the debtor's entire stock in trade. The execution and delivery of this mortgage were held to have been in bad faith and to have constituted an effort to hinder and delay creditors; hence, an act of bankruptcy.⁵

1293. Second act of bankruptcy: giving preference while insolvent. A person commits an act of bankruptcy if, *while insolvent*, he transfers any part of his property to one or more creditors with intent to prefer them over other creditors. If a debtor is solvent, he may prefer to pay any one creditor in full, ahead of the others. No injustice is done thereby, since the debtor's solvency assures payment to the other creditors as well. But if an insolvent debtor pays any one creditor in full, he thereby deprives the others of their ratable share.

Example: Smith has assets of \$50,000 and debts of \$100,000. He owes Allen \$50,000, Brown \$30,000, and Carter \$20,000. He pays Carter's debt in full. Since Smith's assets amounted to 50% of his liabilities, Allen, Brown, and Carter were entitled, respectively, to a distribution of \$25,000, \$15,000 and \$10,000. Smith's preferential payment to Carter deprived Allen and Brown of their ratable shares.

1294. Third act of bankruptcy: permitting lien while insolvent. A person commits an act of bankruptcy if, *while insolvent*, he permits a creditor to obtain a lien through legal proceedings and fails to vacate or discharge the lien within thirty days, or at least within five days before the date set for any sale or other disposition of the property affected by the lien.

The most common lien which a creditor may be permitted to obtain through legal proceedings is by means of a judgment. However, merely procuring a judgment does not necessarily constitute a lien on all of a debtor's property. In order that a judgment shall constitute a lien on a debtor's real property, it must be duly docketed or filed; and in order that it may constitute a lien against the debtor's personal property, it must as a rule be advanced to the point of issuing execution on it to a sheriff or corresponding officer.

1295. Fourth act of bankruptcy: assignment for benefit of creditors. If a person makes a general assignment for the ben-

⁴ *In re Filer*, 108 Fed. 209 (D.C., N.Y.).

⁵ *In re Pease*, 129 Fed. 446.

efit of his creditors, he commits an act of bankruptcy. Such assignments are frequently permitted by state statute. They are also frequently followed by petitions in bankruptcy, filed by creditors dissatisfied with such an assignment.

1296. Fifth act of bankruptcy: appointment of receiver or trustee while insolvent. If a person, either *while insolvent*, or *while unable to pay debts as they mature*, procures, permits or suffers, voluntarily or involuntarily, the appointment of a receiver or trustee to take charge of his property, he commits an act of bankruptcy. Receivership without insolvency does not constitute an act of bankruptcy. The word "insolvency," under this specified act of bankruptcy, is used in both the equity and bankruptcy meanings of the term (sec. 1281). Moreover, receivership as an act of bankruptcy must be general, not special. For example, if a mortgage on the debtor's property is being foreclosed and a receiver is appointed in connection with the foreclosure, such receivership does not constitute an act of bankruptcy.

1297. Sixth act of bankruptcy: written admission. If a person admits in writing his inability to pay his debts and his willingness to be adjudged a bankrupt, he commits an act of bankruptcy. The clearest admission of willingness to be adjudged a bankrupt is, of course, the filing of a voluntary petition in bankruptcy. However, many persons are unwilling to take the formal step of filing a petition in court, and yet are willing to admit their inability to pay their debts and their willingness to be adjudged a bankrupt.

1298. Burden of proving insolvency. When creditors file an involuntary petition under the second, third or fifth acts of bankruptcy, they have the burden of proving insolvency. That is, the law presumes solvency unless the creditor can prove insolvency. Under the first act of bankruptcy, the debtor has the burden of establishing *solvency* if he wishes to urge it as a complete defense. That is, the law presumes insolvency unless the debtor can prove solvency. But even when the burden of proving insolvency is on the creditors, the law will shift this burden to the debtor, and will require him to prove solvency, if he fails to produce his books and records on the hearing. That is, the law in such a case will presume that the debtor is insolvent unless he can prove the contrary.

D. Custody of Property Pending Proceedings

1299. In general. Between the filing of an involuntary petition and the determination of the bankruptcy court as to whether the petition should be dismissed or the debtor adjudicated a bankrupt, there is sometimes danger that the debtor's property may be spirited away and the administration of the bankrupt estate handicapped in case of adjudication. Frequently, too, it becomes necessary to appoint a custodian to protect and preserve the debtor's property pending adjudication. Such custodian may be a receiver or marshal appointed by the court, on petition showing special reasons justifying such appointment.

1300. Grounds for appointment of receiver. Ordinarily, a receiver in bankruptcy will be appointed only when absolutely necessary to preserve assets; for example, when assets are perishable or unprotected, or likely to be wasted, destroyed, stolen, misappropriated, dissipated, secreted or turned over to favored creditors pending adjudication.

Receiver v. trustee. Receivers and trustees differ basically in two respects: (1) A receiver is appointed by the court, whereas a trustee is elected by the creditors; and (2) a receiver's functions are primarily custodial, though he has administrative duties as well, whereas a trustee's duties are primarily administrative, though he takes over custody as an incident to administration.

1301. Powers and duties of receiver or marshal. The receiver or marshal, whenever necessary, may secure an order restraining the bankrupt from transferring any of his property, restraining creditors from attempting to seize any of the debtor's property by legal process or otherwise, and directing the receiver or marshal to seize and hold the property himself pending adjudication. Before the property of an alleged bankrupt can be seized or a receiver appointed pending adjudication, a bond must be given by the person applying for such seizure or appointment, so as to protect the debtor in case it turns out that he was not really bankrupt. Otherwise, he may suffer serious damage without assurance of recompense. Usually, the powers and duties of a receiver or marshal are confined to custody and preservation of assets. All books, papers and records of the alleged bankrupt must be carefully preserved. A receiver or marshal has authority to collect rents, bank accounts or bills receivable owed to the alleged bankrupt.

Ordinarily a receiver has authority to take charge of premises and to continue to occupy them under an existing lease, especially when the alleged bankrupt has assets on the premises. If he surrenders the premises, the landlord's damages are limited by statute. (See secs. 1335 and 1840.)

Ancillary receiver. A bankruptcy court not only has jurisdiction over the assets of a bankrupt in the district of his domicile, but it may appoint an ancillary receiver to take possession and custody of a bankrupt's assets in any outside jurisdiction, when such appointment is necessary to preserve such assets.

1302. Termination of receivership. Temporary custody by the receiver or marshal is terminated upon appointment of the trustee in bankruptcy. The receiver must account for all property and income of the bankrupt estate coming into his hands during the period he had custody, as well as all administration and other expenses incurred during the same period. A receivership may also be terminated by dismissal of the petition in bankruptcy, in which event the receiver, upon surrendering custody to the alleged bankrupt, must likewise make full report covering receivership assets, income and expenses.

E. Administration of Estate

1303. Necessity for administration. If the debtor is adjudicated a bankrupt, it becomes necessary to administer his estate, that is, to take over and collect the bankrupt's assets, convert it into money and, after payment of fees and expenses, to distribute it among creditors in a prescribed order of priority. For this purpose, creditors elect a trustee to act on their behalf under the general supervision of the referee and subject to court direction.

1304. Creditors' meetings. Not less than ten nor more than thirty days after the adjudication, the referee calls and presides over the first meeting of creditors. Subsequent meetings may be called by the referee whenever required. One fourth or more of the creditors may request that subsequent meetings be called. At the first meeting, creditors file "proofs of claim" (sec. 1327).⁶ The referee may allow or disallow any claim.

1305. Voting by creditors. Only creditors whose claims have been allowed may vote at creditors' meetings. Such

⁶ Creditors have six months within which to file their proofs of claim, but only creditors whose claims are filed may vote at meetings.

creditors may vote personally or by a representative. Voting is governed by a majority in number as well as in amount. For example, ten creditors aggregating \$20,000 in claims cannot outvote two creditors with a total of \$50,000 in claims, and neither can the latter outvote the former, because neither group has a majority in number *and* amount. Claims of \$50 or less are counted in computing the amount, but not in computing the number of creditors voting. Secured or priority creditors (secs. 1332 and 1334) may not vote unless the amounts of their claims exceed the values of their securities or priorities.

1306. Appointment of trustee: creditors' committee. The creditors at their first meeting may elect one or three trustees. If they do not elect a trustee, or if the trustee elected fails to qualify, the referee appoints a trustee. The trustee, by operation of law, automatically takes over all the bankrupt's right, title and interest in any of his property, real or personal, tangible or intangible.

The creditors may at their first meeting also designate a committee of not less than three creditors. This committee may consult and advise with the trustee, make recommendations, and submit to the Court any questions affecting the administration of the estate.

1307. Duties of trustee: in general. Primarily, the trustee's function is to collect and reduce to money, under the direction of the court and as expeditiously as possible, all property, real or personal, tangible or intangible, which may belong to the bankrupt, wherever such property may be located and whoever may be in possession of it. All other duties of the trustee are subordinate and incidental to this one. Specifically, the duties of a trustee in bankruptcy are set forth in section 47 of the Bankruptcy Act as follows:

(1) Collect and reduce to money the property of the estates for which they are trustees, under the direction of the Court, and close up the estates as expeditiously as is compatible with the best interests of the parties in interest.

(2) Deposit all money received by them in designated depositories.

(3) Account for and pay over to the estates under their control all interest received by them upon funds belonging to such estates.

(4) Disburse money only by check or draft on such depositories.

(5) Keep records and accounts showing all amounts and items of prop-

erty received and from what sources, all amounts expended and for what purposes, and all items of property disposed of.

(6) Set apart the bankrupts' exemptions allowed by law, if claimed, and report the items and estimated value thereof to the courts as soon as practicable after their appointment.

(7) Examine the bankrupts

(a) at the first meeting of creditors or at other meetings specially fixed for that purpose, unless they shall already have been fully examined by the referees, receivers, or creditors, and

(b) upon the hearing of objections, if any, to their discharges, unless otherwise ordered by the Court.

(8) Examine all proofs of claim and object to the allowance of such claims as may be improper.

(9) Oppose at the expense of estates the discharges of bankrupts when they deem it advisable to do so.

(10) Furnish such information concerning the estates of which they are trustees and their administration as may be requested by parties in interest.

(11) Pay dividends within ten days after they are declared by the referees.

(12) Report to the courts in writing the condition of the estates, the amounts of money on hand, and such other details as may be required by the courts, within the first month after their appointment and every two months thereafter, unless otherwise ordered by the courts.

(13) Make final reports and file final accounts with the courts fifteen days before the days fixed for the final meetings of the creditors.

(14) Lay before the final meetings of the creditors detailed statements of the administration of the estates.

1308. Duty to examine bankrupt. The trustee must examine the bankrupt at the first meeting of creditors, or at other meetings especially fixed for that purpose, unless the bankrupt has already been examined by the referee, receiver or creditors. The trustee must satisfy himself that the bankrupt has withheld no property which should go into the estate, and that he has not been guilty of a voidable preference, transfer or lien in favor of some particular creditor or creditors. (See sec. 1323.)

1309. Duty to set aside voidable preferences, transfers and liens. It is a trustee's duty to take the necessary steps to set aside any unlawful preference, transfer or lien. A solvent person, as noted in section 1293, may prefer any creditor he pleases; but an insolvent person cannot prefer one creditor before another without causing injury to the latter. Similarly, when an insolvent person transfers any of his property for an inadequate consideration or permits a lien to be placed on his property for the benefit of a favored creditor, he thereby depreciates the value of the estate available to creditors generally.

What constitutes voidable preference. A preference is not voidable unless the following elements are present: (1) a transfer; (2) insolvency at time of transfer; (3) the transfer's being made within four months before filing of petition, or after filing and before adjudication; (4) the creditor's obtaining a greater percentage of his debt than other creditors of the same class; and (5) the transferee's having reason to believe that the transfer will effect a preference.

Transferee's knowledge of debtor's insolvency. The Bankruptcy Act⁷ provides that the trustee may set aside a voidable preference *provided the transferee, at the time of the transfer, has reasonable cause to believe that the debtor is insolvent.* Mere suspicion of insolvency is insufficient.⁸

Example: An insolvent father transfers stock to his son just prior to bankruptcy. The son borrows \$5000 at the bank for his own use, and as security, pledges the stock he got from his father. The trustee in bankruptcy seeks to set aside the transfer and the pledge. On the assumption that the son had reason to believe that his father was insolvent, the transfer to the son could have been set aside, but the question whether the pledge to the bank could be set aside would depend upon whether the bank, at the time of the pledge, knew of the transfer from father to son and had reason to believe that the father was insolvent.

Voidable liens. The Bankruptcy Act⁹ defines a voidable lien as one obtained by attachment, judgment, levy, or other process within four months before the filing of a petition when (a) at the time the lien was obtained the debtor was insolvent, or (b) the lien was sought or permitted in fraud of the act.

When liens are valid notwithstanding insolvency. Statutory liens for taxes and debts due the government, and liens in favor of employees, contractors, mechanics, landlords, and so on, may be valid even though created or perfected while the debtor was insolvent and within four months prior to the filing of the petition.

1310. Trustee's duty to assume or reject contract. The trustee is allowed sixty days after adjudication within which to assume or reject any executory contract (sec. 173) to which the bankrupt is a party. If the contract has been executed by the other party, that is, if the bankrupt has already received the benefit of the contract, the trustee may neither assume nor reject; the estate is liable, and the other party has a valid claim against the estate.

1311. Actions by or against trustee. A trustee in bankruptcy may bring any action in any court in behalf of the bankrupt estate and for the benefit of creditors, and may conduct such

⁷ Section 60, subd. b.

⁸ *Grant v. Nat'l Bank*, 97 U.S. 80; *Batchelder v. Home National Bank*, 210 Mass. 420.

⁹ Section 67.

suit, continue it or discontinue it as his own discretion may dictate in the interests of the creditors. For this purpose he may retain an attorney or attorneys to represent him. Formerly, an attorney could not represent a trustee if he also represented a general creditor. This is no longer the law. Trustees may not only bring suit in outside courts, but suit may be brought against them to enforce any claims or rights other than those ordinarily provable by filing a proof of claim in bankruptcy.

1312. Trustee's duty to account. Within the first month after his appointment, and every two months thereafter, the trustee must render an accounting to the court concerning his administration of the estate. He must make a final report and file his final account, fifteen days before the day fixed for the final meeting of creditors; and he must lay before such final meeting a detailed statement of the administration of the estate.

1313. Objections; surcharge; approval; discharge. Any party in interest may object to the trustee's account upon a hearing set for such purpose. The referee sustains such objections if they are meritorious and overrules them if they are not. So long as the bankrupt estate has not been closed and the trustee has not been discharged, his accounts are subject to inspection and audit by the Court. If, by some wrongful act or omission of the trustee, the estate has suffered loss, the trustee may be *surcharged*, or held personally liable for such loss. If a trustee's account is not objected to, and the referee finds it in order, the account will be approved and the trustee discharged. The estate is thereupon closed.

F. Rights, Duties and Liabilities of Bankrupt

1314. Right to counsel. Whether proceedings be voluntary or involuntary, a bankrupt is entitled to counsel so that he may be duly advised of his legal rights. However, the court may re-examine any fee which the bankrupt pays his attorney in contemplation of bankruptcy, and may require any amount deemed in excess of a reasonable fee to be turned over to the estate as an unlawful preference.

1315. Exemptions of bankrupts generally. State laws throughout the country prescribe various personal exemptions immune from legal process, such as wearing apparel, wages,

jewelry, and so on, and various forms of occupational exemptions, such as growing crops, tools and implements of trade. What may constitute an exemption for one person will not necessarily constitute an exemption for another.

Examples:

(1) Pianos as part of a stock in trade would not ordinarily be exempt; but a piano used principally in the teaching of music and constituting a part of the household furniture has been held to be exempt.¹⁰

(2) An ordinary ring, such as a wedding ring, might be exempt, but a diamond ring has been declared not to be exempt.¹¹

1316. Insurance exemptions: in general. The rights of bankrupts in connection with insurance policies depend upon whether the policy covers property or life.

Property insurance. The rule governing property insurance is fairly uniform: a bankrupt's property insurance forms part of his estate, and the bankrupt is entitled to no exemption in respect to such insurance.

Life insurance. In regard to life insurance, the rule is not uniform. To determine the bankrupt's rights in respect to life insurance, it is necessary to consider whether the bankrupt is himself the policyholder, thus having an interest in the cash surrender value of the policy (sec. 987), or whether he is the beneficiary under a policy insuring the life of another. Even with this distinction, the rule varies in the different states, and the question of a bankrupt's exemptions is governed by the law of the state where the bankrupt is domiciled.

1317. Duties of bankrupt: in general. The primary duty of a bankrupt is to surrender all his property of whatsoever nature, except property exempt by law. The act charges the bankrupt with specific duties, including attendance at meetings, obedience to court orders, verification of proofs of claim and reporting irregularities therein to the trustee, the execution and delivery of all necessary papers, the preparation of schedules, the submission of a preliminary statement of his affairs, the submission of himself to examination, and the filing of cost inventories when required by the Court.

1318. Attendance at creditors' meetings. The bankrupt must attend the first meeting of creditors, the hearing upon objections to his discharge, if any, and at such other times as the court may order. Attendance at the first meeting of creditors is particularly important, so that the bankrupt may assist

¹⁰ *Hill v. Binford*, 91 S.W. (2d) 488 (Tex. Civ. App.).

¹¹ *Rivas v. Noble*, 241 Fed. 673, 154 C.C.A. 431 (Fla.); *Langever v. Stitt*, 237 Fed. 83, 150 C.C.A. (Tex.) 285.

in checking creditors' claims and help to determine, in case of dispute, which creditors are qualified to vote and which are not. The bankrupt must attend both the first meeting of creditors and the hearing on objections, if any, to his discharge, without the necessity of any order being served upon him for this purpose. In all other cases, the bankrupt is not required to attend meetings unless ordered by the Court to do so.

1319. Verifying proofs of claim and reporting irregularities. The bankrupt must examine and report to the trustee concerning the correctness of all proofs of claim filed against his estate. He must immediately inform his trustee of any attempt which comes to his knowledge, by creditors or other persons, to evade the provisions of the Bankruptcy Act. If the bankrupt learns that any person has proved a false claim against the estate, he must make immediate disclosure of this fact to the trustee.

1320. Execution and delivery of papers; obedience to court orders. The bankrupt must execute and deliver such papers as may be ordered by the Court, including the execution and delivery to the trustee of any documents necessary to transfer property in foreign countries. He must comply strictly with all orders of the Court. For a failure to do so, he may be arrested and punished for contempt, either by fine, imprisonment or both. In addition, such noncompliance will bar his discharge in bankruptcy.

1321. Preparation and filing of schedules. The bankrupt must prepare in triplicate, make oath to, and file, within five days after adjudication if he is an involuntary bankrupt, and with his petition if he is a voluntary bankrupt, a schedule of his property showing amount, kind, location, and value of each item, and a list of all creditors—whether their claims be liquidated or unliquidated, fixed or contingent, disputed or admitted—showing their names, residences, amounts due and similar details.

1322. Preliminary statement of affairs: advance information before first meeting. Prior to 1938 attorneys for creditors desiring to examine a bankrupt at the first meeting of creditors were handicapped by absence of advance information. Examinations were necessarily "fishing expeditions" for possible irregularities, clues to hidden assets, and so on. The Bankruptcy Act of 1938 made it obligatory upon bankrupts to furnish a preliminary statement of affairs in advance of the first

meeting, as an intelligent basis upon which to examine the bankrupt. This statement must be filed in triplicate with the court at least five days prior to the first meeting of creditors, on a form prescribed by the Supreme Court. One form governs bankrupts or debtors who are not engaged in business, and another those who are.

1323. Examinations. At the first meeting of creditors, at the hearing upon objections to his discharge, if any, and at such other times as the court may order, the bankrupt must submit to an examination concerning the conduct of his business, the cause of his bankruptcy, his dealings with creditors and others, the amount, kind and whereabouts of his property, and all matters which may affect the administration and settlement of his estate or the granting of his discharge.

1324. Inventory of costs. The court may require a bankrupt to file an inventory of costs as of the date of bankruptcy, as a basis for checking any claim that goods were sold at a loss. In the absence of a cost inventory, where ordered, the Court presumes that the bankrupt's goods were not sold at a loss. Likewise, if the bankrupt fails to produce books and records showing cost of goods sold, he has the burden of proving that sales were made at a loss.

1325. Liability to arrest. A bankrupt is not only liable to arrest and imprisonment for the commission of one of the bankruptcy offenses, but of course he is subject to imprisonment for the commission of any other crime under the laws of any state. Bankruptcy proceedings can in no way be allowed to impede the prosecution of persons for crimes such as larceny, embezzlement, arson, and so on, except that when a person is imprisoned for the commission of such crimes, he may be temporarily taken out of jail for the purpose of attending bankruptcy hearings requiring his presence. When it is claimed that a bankrupt has been imprisoned without just cause, the proper remedy is to obtain a hearing on the cause of his detention. This can be done on a writ of *habeas corpus*, which can be signed only by the judge.

1326. Death or insanity of bankrupts. The death or insanity of a bankrupt does not abate the proceedings; the estate continues to be administered and is concluded in the same manner, as far as possible, as if the bankrupt had not died or become insane. However, as previously pointed out (sec. 1209) bank-

ruptcy proceedings cannot be instituted against the estate of a deceased person.

G. Proof, Allowance and Payment of Claims

1327. Proofs of claim: nature, form and contents. A proof of claim in bankruptcy is a statement under oath signed by a creditor setting forth the facts in reference to his claim. These facts include the amount and consideration for the claim; whether the claim is secured, and if so, how; whether any payments have been made on the claim, and if so, what; together with an affirmation that the sum claimed is justly owing from the bankrupt to the creditor. If a claim is founded on a written instrument, the original instrument must be attached.

1328. Time for filing proofs of claims. Proofs of claims must be filed with the court or referee within six months after the first date set for the first meeting of creditors. As previously noted, however, if a creditor wants to vote at the first meeting, he must first file his proof of claim. If a creditor fails to file his proof of claim within the time allowed by law, his claim is lost. It matters not that the claimant had no notice or knowledge of the bankruptcy proceedings until after the time had expired.¹² Neither does it matter that the claim was lost in the mail; if the time has expired before the loss is discovered, the law allows no extension of time.¹³ Even when the claim was sent to attorneys who neglected to file it, but who informed the claimant that it had been filed, the Court was held to have no power to order the claim filed after the expiration period.¹⁴

Tax claims entitled to priority under the Bankruptcy Act need not be regularly and formally proved. It is the trustee's duty to pay them whenever they are brought to his attention.¹⁵ Tax claims may therefore be presented at any time during the pendency of the bankruptcy before the funds have been distributed.¹⁶ "Accordingly, the bankruptcy court will pass upon a claim for taxes and its legality and amount without a proof

¹² *First Nat. Bank v. Virginia Oil & Refining Co.*, 86 Fed. (2d) 770 (C.C.A., Tex.); certiorari denied, 57 S. Ct. 669.

¹³ *In re R. B. Rose Co.*, 43 Fed. (2d) 446 (D.C., N.Y.); *In re Harris Bros.*, 5 Fed. Supp. 191 (D.C., Ark.).

¹⁴ *Tarbell v. Crex Carpet Co.*, 90 Fed. (2d) 683 (C.C.A., Minn.).

¹⁵ *In re De Angeles*, 36 Fed. (2d) 218 (C.C.A., Utah); *In re Chandler Motors of New England*, 17 Fed. (2d) 998 (D.C., Mass.).

¹⁶ *U.S. v. Birmingham Trust & Savings Co.*, 258 Fed. 562 (C.C.A., Ala.), certiorari denied, 251 U.S. 550.

of claim having been filed; but the taxes must in some manner be brought to the attention of the court or the trustee before the assets of the estate have been distributed in order to have a right of action for the nonpayment thereof.”¹⁷

1329. Provable claims. Not every claim is provable in bankruptcy. Only those claims which are specifically enumerated in the Bankruptcy Act¹⁸ may be proved, namely, the following:

Fixed liabilities, as evidenced by a judgment or a written instrument absolutely owing at the time of the filing of the petition, *whether then payable or not*, with interest as of the filing date, or rebate of interest if interest was prepaid. Debts reduced to judgment after the filing of the petition and before the bankrupt's application for discharge comes up for consideration are also provable.

Liabilities on open account, or on contract, express or implied, including claims for anticipatory breach of contracts (sec. 237), and unexpired leases (within the limits referred to in section 1335).

Contingent claims, including contingent debts and contractual liabilities, and rights to recover damages in negligence actions commenced prior to and pending at the time of the filing of the petition.

Workmen's compensation awards against the bankrupt for injuries occurring prior to adjudication.

Court costs incurred by a creditor before the filing of the petition or awarded against a bankrupt who, at the time the petition was filed, was plaintiff in an action which the trustee later declines to prosecute.

The foregoing claims, which involve money demands, are subject to *reclamations* and *trust claims*. They are also subject to the rights of *secured creditors* and to a fixed order of *priority* in payment.

1330. Reclamations. If a person claims specific property in the bankrupt estate as his own, he must bring “reclamation proceedings” for the recovery of such property, instead of filing a proof of claim. If he files a proof of claim, he forfeits his right to the specific property and becomes relegated to the status of a creditor.¹⁹

(See sec. 586, “Where broker becomes insolvent: rights of customer as to deposited securities.”)

1331. Trust claims. When a bankrupt holds property in trust, the beneficiary, as equitable owner, may reclaim the property or its proceeds. The beneficiary is not, strictly speaking, a creditor entitled to priority but a claimant entitled

¹⁷ 8 *Corpus Juris Secundum* 1285, and cases therein cited.

¹⁸ Section 63.

¹⁹ *Lowell v. Brown*, 280 Fed. 193, aff'd 284 Fed. 936 (reversed on other grounds, 265 U.S. 1).

to specific property or a specific fund. (See sec. 1217, subd. (3).)

Checks drawn prior to bankruptcy. When the depositor of a bank, prior to his bankruptcy, issues a check which is not presented until after his bankruptcy, the holder has no claim to any specific fund. The mere issuance of a check does not constitute an equitable assignment of the funds drawn against. But if the check has in the meantime been honored, as by certification, or by being credited to the payee on the books of the bank, an equitable assignment takes place, and the holder may establish a specific claim upon the fund represented by the check. (See section 1839).

1332. Secured, "preferred," and general creditors distinguished. A *secured* creditor is defined by the Bankruptcy Act²⁰ as "a creditor who has security for his debt upon the property of the bankrupt of a nature to be assignable under this Act or who owns such a debt for which some endorser, surety, or other person secondarily liable for the bankrupt has such security upon the bankrupt's assets."

Examples: The following are secured creditors under the Bankruptcy Act: (1) one who holds the bankrupt's bond secured by a mortgage, (2) one who holds the bankrupt's note guaranteed by a third party who holds security belonging to the bankrupt.

A "preferred creditor," literally, is one who has been given a preference (sec. 1293). Frequently, however, the term is incorrectly used to designate a *priority creditor*, or one whose claim has priority over the claims of general creditors.

A *general* creditor is one who has no security or priority.

1333. Rights of secured creditors. Creditors who are fully secured may resort to their security in satisfaction of their claims. If there is anything left after the claim is satisfied, the surplus goes to the trustee in bankruptcy. When the value of the security obviously exceeds the amount of the claim, a creditor has no right to vote at meetings, nor, of course, to dividends in bankruptcy.

Claims of partially secured creditors. When a creditor's claim is only partially secured, he is entitled to vote on the basis of his unsecured debt,²¹ and may participate in dividends only to such extent.

²⁰ Sec. 1, subd. 28.

²¹ "Claims of secured creditors and those who have priority may be temporarily allowed to enable such creditors to participate in the proceedings at creditors' meetings held prior to the determination of the value of their securities or priorities, but shall be thus temporarily allowed for such sums only as to the courts seem to be owing over and above the value of their securities or priorities." *Bankruptcy Act*, sec. 57, subd. e.

Example: A creditor holds a bankrupt's note for \$2500. The note is secured by collateral worth \$1800. A 40% dividend is declared to general creditors. The value of the note will equal \$1800, plus \$280, which is 40% of the unsecured balance, or a total of \$2080. (See sec. 1845, subd. (c).)

1334. Priorities. Debts are accorded priority over the claims of general creditors in the following order:

(1) *Actual and necessary costs and expenses of preserving the estate* after the filing of the petition. These include filing fees, expenses of recovering concealed or fraudulently transferred assets, trustee's expenses, attorney's fees, and so on.

(2) *Wage claims* (not exceeding \$600 to any claimant) which have been earned within three months before bankruptcy, including claims of full or part time salesmen on salary or commission. The Bankruptcy Act definition of a wage earner refers only to the classification of persons who may be adjudged involuntary bankrupts (sec. 1286) and is not intended to refer to wage earners as creditors. A wage earner, to be entitled to priority, is one who serves in a subordinate capacity "otherwise than in the pursuit of an independent calling" and who, in such service, "remains entirely under the control and direction of the employer." However, the court in laying down this rule held that musicians hired by a bankrupt to play on his roof garden are "servants" entitled to priority on their wage claims.²² Neither the general manager of a corporation²³ nor a certified public accountant who audits the books of a bankrupt firm²⁴ is classed as a wage earner entitled to priority.

(3) *Costs and expenses of creditors* for successfully opposing, revoking or setting aside a plan of arrangement, or a wage earner's plan, or a bankrupt's discharge; or in securing the conviction of any person for a bankruptcy offense.

(4) *Tax claims.* Taxes are a prior claim upon a bankrupt estate, and any fiduciary who pays a private debt ahead of taxes runs the risk of being personally liable for such taxes if the estate is unable to pay them. The statute provides²⁵ that every executor, administrator, assignee or other person who pays, in whole or in part, any debt due by the person or estate for whom or for which he acts, before he satisfies and pays the debt due the United States from such person or estate, shall become answerable personally to the extent of such payments for the debt so due, or for so much of it as remains due and unsatisfied. A trustee is similarly liable for rendering an estate unable to pay state taxes. However, a trustee is not liable if he had no notice of the existence of the tax.²⁶

²² *In re Caldwell*, 164 Fed. 515 (D.C., Ark.).

²³ *In re Grubbs-Wiley Grocery Co.*, 96 Fed. 183 (D.C., Mo.).

²⁴ *Matter of Samek & Robel, Inc.*, 5 Am. B. R. (N.S.) 683.

²⁵ U.S. Rev. St. sec. 3467, 31 U.S.C.A. sec. 192.

²⁶ *State of Delaware v. Irving Trust Co.*, 92 Fed. (2d) 17 (C.C.A., N.Y.), aff'g 19 Fed. Supp. 231 (D.C., N.Y.); certiorari denied, 302 U.S. 754.

(5) *Debts entitled to priority by Federal law, and rent due and owing for actual use and occupancy* (accrued within three months prior to bankruptcy) to a landlord entitled to priority under the laws of a particular state.

Example: Mary Moore, owner of a business corner in Miami, Fla., files a claim for three months' rent as a priority creditor of Universal Drug Shops, Inc., a nationwide chain store organization which has been adjudicated a bankrupt in the Southern District of New York. Since such rent claims are recognized as prior liens under the laws of Florida (though not in New York), the priority will be allowed.

(6) *Debts contracted after the granting of a discharge or after the confirmation of an arrangement, where the discharge or confirmation is subsequently revoked or set aside for fraud or similar reason.*

1335. Landlord and tenant claims. Bankruptcy claims arising between landlord and tenant have been a source of frequent dispute and conflicting decisions.

Bankruptcy of landlord: When the landlord becomes bankrupt, his leasehold interest goes to the trustee in bankruptcy, the same as any other asset, and the tenant's rights are generally unaffected.

Landlord's claim for rent due and unpaid at time of tenant's bankruptcy. When, at the time of the tenant's bankruptcy, there is a balance due and accrued for unpaid rentals, the claim for such rent is a fixed liability and is provable as such.

Claims based on unexpired leases. Formerly, a landlord's claim against a bankrupt tenant, to be provable, had to be actually due and owing at the time of bankruptcy. Future rents under unexpired leases were generally held to be nonprovable, hence not dischargeable, so that bankrupts frequently found themselves burdened with heavy lease obligations notwithstanding a discharge in bankruptcy. The Bankruptcy Act of 1938 made claims based on unexpired leases provable, hence dischargeable. As noted in section 1329, provable claims in bankruptcy include anticipatory breaches of contract. The trustee has sixty days after adjudication within which to approve or reject the bankrupt's executory contracts. Disaffirmance of an unexpired lease may be treated by the landlord as a breach of contract, which constitutes a provable claim. However, the maximum damage which a landlord may claim in such cases, regardless of how much longer the lease still has to run, is a year's rent from the date of surrender of the premises or re-entry by the landlord (whichever occurs first) plus rent previously accrued.

1336. Unmatured claims. As noted in section 1329, fixed liabilities evidenced by a judgment or a written instrument are provable claims in bankruptcy, whether they are *then payable or not*.

Example: A holds B's note due in three years. Six months after date B is adjudged bankrupt. A may prove his claim, though the note has two

and a half years to run. If *A* fails to prove his claim, the debt, being provable, will be discharged in bankruptcy.

1337. Claims as offsets. Section 68 of the Bankruptcy Act provides: "In all cases of mutual debts or mutual credits between the estate of a bankrupt and a creditor the accounts shall be stated and one debt shall be set off against the other, and the balance only shall be allowed or paid."

Example: *A* borrows \$2000 at the bank, against his note. He leaves \$1500 on deposit. In contemplation of filing a petition in bankruptcy, he gives the bank a check for the full amount of his deposit, which the trustee seeks to recover as an unlawful preference. The trustee will not succeed. The check conferred no right on the bank which the bank did not have anyway, that is, a right to offset \$1500 of its \$2000 claim on the note against its \$1500 debt to *A* on the bank account.²⁷ The fact that *A*'s note was not due is immaterial. Under section 63 of the Bankruptcy Act, a claim based on a written instrument absolutely owing is provable whether due at the time of the petition or not.

The foregoing rule applies only in bankruptcy. A bank cannot ordinarily anticipate the due date of a depositor's note by appropriating the amount of his balance.

1338. Relative rights of partnership and individual creditors. When a partnership is declared bankrupt, the separate assets of all partners, as well as the partnership estate, are drawn into bankruptcy. This applies also where members of a partnership individually and as copartners are adjudged bankrupts. However, the bankruptcy of a partner does not draw in the partnership property except with the consent of the remaining partners, or unless the bankrupt is the sole surviving member of the firm and has control of the partnership assets.²⁸ In the administration of a bankrupt partnership estate, the Bankruptcy Act recognizes the rule of *marshaling assets*. Firm assets must first be made available for payment of firm debts, and the partners' individual assets for the payment of their respective individual debts. If, after payment of firm debts, a surplus remains, such surplus—in which each individual partner has an undivided interest—may be applied to the payment of the partners' individual debts. If, after a partner pays his personal debts out of his personal assets, a surplus remains, such surplus may be applied to the payment of firm debts, provided firm assets are insufficient for this purpose.

²⁷ *N.Y. County Nat'l Bank v. Massey*, 192 U.S. 138.

²⁸ 8 *Corpus Juris Secundum* 428-429.

1339. Objections to and allowance of claims. Ordinarily, the filing of a proof of claim, duly executed and in proper form, constitutes *prima facie* evidence (sec. 78) of the claim; and the claim will be allowed unless an objection is filed. The allowance of a claim may be objected to by any party interested in the estate. The trustee in bankruptcy *must* object to the allowance of any doubtful claims; and any creditor *may* object. Upon the filing of objections, a hearing is held before the court or referee, and upon the evidence adduced at such hearing, the claim is either allowed or disallowed.

Usurious claims against a bankrupt's estate will be disallowed, unless the bankrupt is a corporation. A trustee may urge the same defenses against creditors that the bankrupt himself might have urged in the absence of bankruptcy.

1340. Dividends in bankruptcy. A dividend in bankruptcy represents a proportion of assets in a bankrupt estate available for distribution to general creditors. We have already noted the respects in which dividends in bankruptcy differ from dividends paid by a corporation (sec. 848). Dividends are declared by the referee and paid by the trustee. The first dividend must be declared within thirty days after the first date set for the first meeting of creditors, provided the amount in the estate in excess of the amount necessary to pay debts which have priority, equals 5% or more of claims which have been and probably will be allowed. The first dividend cannot exceed 50% of the surplus over the moneys necessary to pay claims having priority and claims not yet allowed. A final dividend cannot be declared until three months after the first one. The dividend rate must be uniform as to all unsecured creditors.

1341. Claims allowed after dividend declarations. The rights of creditors who have received dividends, or in whose favor final dividends have been declared, are not affected by the subsequent proof and allowance of claims. However, before such creditors are paid any further dividends, subsequent claimants are entitled to receive dividends equal in amount to those already received by the others.

1342. Unclaimed moneys. Dividends or other moneys which remain unclaimed for sixty days after the final dividend has been paid and distributed must be paid by the trustee into the bankruptcy court. The trustee must file a list of the

names and post-office addresses, as far as known, of the persons entitled to such moneys and the amounts respectively due them. Dividends remaining unclaimed for one year are distributed to creditors whose claims have been allowed and not paid in full. If such claims have been paid in full, the balance is paid to the bankrupt.

H. Discharge of Bankrupt

1343. **In general.** Under the old Bankruptcy Act a bankrupt could apply for a discharge after the expiration of one month and within twelve months subsequent to adjudication. As a matter of practice the bankrupt, choosing his own time in applying for a discharge, often waited until creditors had lost interest, so that there would be little chance of opposition. Under the Bankruptcy Act as amended in 1938, after the bankrupt has been examined, the court itself fixes the time for filing objections to a discharge. Notice must be given to all interested parties. The United States Attorney, when requested by the Court, must examine into any case to ascertain whether there are probable grounds for denying a discharge. If he finds such grounds, he must oppose the discharge. Under the old practice there were often such grounds, but not so often a creditor willing to foot the bill for sustaining them.

1344. **Acts which will bar discharge.** A bankrupt will be unable to obtain his discharge in bankruptcy if it can be shown that he has been guilty of any of the following acts:

(a) *Committed a bankruptcy offense.* (See sec. 1349.)

(b) *Destroyed, mutilated, falsified, concealed or failed to keep or preserve books of account or records* from which his financial condition and business transactions might be ascertained, unless in the opinion of the Court such act or omission was justified.

(c) *False statements.* If the bankrupt has obtained money or property on credit, or obtained an extension or renewal of credit, by a false statement in writing as to his financial condition, he will be denied a discharge.

(d) *Removing, destroying or concealing property.* If the bankrupt has transferred, removed, destroyed or concealed any of his property *within twelve months prior to the filing of the petition in bankruptcy*, or has permitted the same to be removed, destroyed or concealed with intent to hinder, delay or defraud creditors, he cannot obtain a discharge in bankruptcy.

(e) *Prior discharge or composition.* The act bars a discharge if the bankrupt "has within six years prior to bankruptcy been granted a discharge, or had a composition or an arrangement by way of composition or

a wage earners' plan by way of composition²⁹ confirmed under this Act." Such prior discharge or composition will constitute a bar whether the subsequent bankruptcy proceedings are voluntary or involuntary.

(f) *Refusal to obey court order or answer material question.* The act bars a discharge to a bankrupt if in the course of a proceeding he has "refused to obey any lawful order of, or to answer any material question approved by, the court."

(g) *Failure to explain loss or deficiency.* The act bars a discharge to a bankrupt if he "has failed to explain satisfactorily any losses of assets or deficiencies of assets to meet his liabilities."

Example: A bankrupt sought to explain away a large portion of his loss by stating that he sold goods at less than wholesale cost over a period of a year because it was necessary to meet competition, and that \$5000 was lost in this manner. Said the court: "The only basis for arriving at this amount was that the bankrupt concluded he had lost about 20 to 25 per cent on the \$28,000 worth of goods which he turned over during the year. In view of the fact that at best this can be regarded only as an estimate by the bankrupt, founded upon nothing which in any way verifies or affirms it, the explanation cannot be regarded as satisfactory."³⁰

1345. Debts not dischargeable. The effect of a discharge in bankruptcy is to release the bankrupt of all civil obligations provable in bankruptcy, with the exceptions noted below. (See sec. 1830, subd. (e).) As indicated in section 1335, only debts which are provable in bankruptcy (sec. 1329) are dischargeable. If this were not so, many creditors would not only be unable to prove their claims in bankruptcy, but would likewise be barred from proving their claims after the bankrupt's discharge. The most common instance of a debt not provable, hence not dischargeable in bankruptcy, is one arising out of goods sold, money loaned or services rendered after the commencement of a bankruptcy proceeding. Again, in some situations claims have potential existence during bankruptcy and do not acquire actual existence until after discharge. Since such claims are not provable, they are not dischargeable.

Example: A bankrupt surety is discharged on his unmatured bond. A cosurety is later required to pay the bond when it matures. The cosurety seeks to hold the discharged bankrupt for his contributory share (sec. 933). The former bankrupt pleads his discharge as a defense. Such defense will not avail; the cosurety's claim for contribution was not in existence during bankruptcy.

However, not all debts which are provable are necessarily on that account dischargeable. The following classes of prov-

²⁹ Sec. 1353.

³⁰ *In re Beckman*, 6 Fed. Supp. 957 (D.C., N.Y.).

able debts are not dischargeable in bankruptcy, and will survive as obligations notwithstanding the bankrupt's discharge:

(a) *Taxes*. The act provides that taxes shall not be dischargeable in bankruptcy. These include not only Federal taxes, but also taxes levied by any state, county, district or municipality.

(b) *Liability for obtaining money or property by false pretenses or representations*. It matters not whether the false representations were made orally or in writing, nor whether they were made directly to the creditor seeking to have the debt excluded from the discharge. If the statement was made to a mercantile agency, for example, the claim is not dischargeable.³¹

(c) *Liability for wilful and malicious injury to person or property*. The court may determine whether the injury in question was wilful or malicious.

Examples:

(1) A judgment for assault and battery would constitute a liability for wilful and malicious injury.

(2) A bankrupt permitted his three-year-old son to use a B-B gun in shooting at cats, birds and his own playmates, in consequence of which one of the playmates lost the sight of one eye. Held, the liability was not dischargeable.³²

(3) Wilful and malicious hypothecation by a broker of securities owned by a customer outright (not on margin).

(d) *Liability for maintenance or support of wife or child*. Claims of this character concern not only the parties themselves, but the state as well. Hence public policy requires that such obligations should not be dischargeable in bankruptcy.

(e) *Alimony*. Liability for alimony due or to become due is not dischargeable.

(f) *Certain torts*. Liabilities for seduction, or for breach of promise of marriage accompanied by seduction, or for criminal conversation, are not dischargeable.

(g) *Debts not duly scheduled*. The act provides that debts shall not be dischargeable in bankruptcy if they "have not been duly scheduled in time for proof and allowance, with the name of the creditor, if known to the bankrupt, unless such creditor had notice or actual knowledge of the proceedings in bankruptcy." In the absence of such a provision, a creditor might well be prejudiced by failure to learn of the bankruptcy in time to permit him to file his proof of claim within the time allowed by law.

(h) *Debts created by fraud, embezzlement, and so on in official or fiduciary capacity*. The act renders nondischargeable all debts of a bankrupt which "were created by his fraud, embezzlement, misappropriation or defalcation while acting as an officer or in any fiduciary capacity."

Examples:

(1) Failure by postmaster to account for government funds.

³¹ *Katzenstein v. Reid & Co.*, 41 Tex. Civ. App. 106, 91 S.W. 360.

³² *In re Papale*, 17 Fed. Supp. 146 (D.C., N.Y.).

(2) Liability of sheriff for profits made out of government moneys entrusted to him for the safekeeping, care and feeding of prisoners.

(3) Liability of officer of a corporation who, with knowledge of its insolvency, transferred corporate assets to himself and his son to liquidate their own claims against the corporation. (See sec. 892.)

(i) *Wages*. Debts due for wages which have been earned within three months before the date of commencement of the bankruptcy proceedings are not dischargeable.

(j) *Employees' security deposits*. A bankrupt is not discharged as to any moneys deposited with him by an employee as security for faithful performance.

1346. Revival of debt discharged in bankruptcy. As noted in sections 152 and 189, a subsequent or new promise, *in writing*, to pay a debt discharged in bankruptcy revives the debt. When a person orally agrees to revive a debt discharged in bankruptcy and then gives a note pursuant to such agreement, the statute of frauds is satisfied, because the note would represent a promise in writing to pay a debt discharged in bankruptcy and would be enforceable.³³

1347. Revocation of discharge. The Bankruptcy Act provides³⁴ that "The court may, upon the application of parties in interest who have not been guilty of undue laches, filed at any time within one year after a discharge shall have been granted, revoke it if it shall be made to appear that it was obtained through the fraud of the bankrupt, that the knowledge of the fraud has come to the petitioners since the granting of the discharge and that the actual facts did not warrant the discharge."

I. Bankruptcy Offenses

1348. In general. The Bankruptcy Act prescribes various forms of punishment for offenses committed by persons connected, officially or otherwise, with the administration of an estate in bankruptcy. Not only are the persons who actually commit the bankruptcy offenses punishable, but all persons who aid, counsel, procure or induce their commission are themselves guilty of a felony warranting their indictment as principals (not, as formerly, mere accessories to the crime). Thus, attorneys and accountants who, by advice, suggestions or otherwise, assist a client in respect to any of the offenses re-

³³ *Stokes v. Sanders*, 181 App. Div. 249, 168 N.Y. Supp. 409.

³⁴ Sec. 15.

ferred to in section 1349, are equally guilty with their clients of a felony warranting their indictment as principals rather than accessories.

1349. Miscellaneous offenses. A person is punishable by imprisonment for a period not exceeding five years, or by a fine of not more than \$5000, or both, upon conviction of the offense of having knowingly and fraudulently:

(a) concealed from the receiver, custodian, trustee, marshal or other officer of the court charged with control or custody of property, or concealed from creditors in any bankruptcy proceeding, any property belonging to the bankrupt estate; or

(b) made false oath or account in relation to any proceeding in bankruptcy; or

(c) presented, under oath, any false claim against the estate, or used any such claim in any bankruptcy proceeding, either personally or by agent or attorney; or

(d) received property from a bankrupt after the filing of a petition or a proceeding, with intent to defeat the purpose of the law; or

(e) received or attempted to obtain money, property, compensation, reward or advantage, or a promise of the same, from any person for acting or forbearing to act in any proceeding under the Bankruptcy Act; or

(f) while an agent of any person, or officer of any corporation, and in contemplation of a bankruptcy proceeding, or with intent to defeat the provisions of the Bankruptcy Act, concealed or transferred any property of such person or corporation; or

(g) after the commencement of a bankruptcy proceeding, or in contemplation thereof, has concealed, destroyed, mutilated, falsified or made a false entry in any document affecting the property or affairs of a bankrupt; or

(h) after the commencement of a bankruptcy proceeding, has withheld from the receiver, custodian, trustee, marshal or other officer of the court, any document affecting the property or affairs of the bankrupt, to the possession of which such officer is entitled.

J. Corporate Reorganization

1350. In general. The nature and purpose of corporate reorganizations generally and the different ways of bringing them about other than through bankruptcy have already been discussed (sec. 897). For many years corporate reorganization through bankruptcy was brought about through the filing of a petition in bankruptcy, followed by a composition, or settlement, upon which the corporate assets were sold to a new corporation which often had the same name as the old, with a corporate setup designed to conform to the composition agree-

ment and the original scheme of reorganization. The 1934 amendment of the Bankruptcy Act, particularly section 77B, provided a plan of corporate reorganization which, on majority acceptance and court approval, could overcome a recalcitrant minority. In practice, however, the administration of corporate reorganizations under section 77B revealed glaring abuses, calling for change.

1351. Outstanding features of corporate reorganization under present Bankruptcy Act. The Bankruptcy Act of 1938 was designed, among other things, to establish a new procedure for corporate reorganization (embodied in Chapter X of the act). Every petition for corporate reorganization must show in the petition why adequate relief cannot be had by an "arrangement" proceeding (sec. 1352). This is to prevent corporate reorganizations from being used by insolvent corporations with no chance of reorganization, solely for the purpose of settlement or delay. In every case where a debtor corporation's scheduled liabilities are \$250,000 or over, the court must, and in every other case the court may, appoint a disinterested trustee. The disinterested trustee's attorney must likewise be disinterested. Such trustee must on his own initiative examine the affairs of the debtor corporation and the conduct of its business, so as to ascertain the reasons for its failure, the probability of success in the event of reorganization, and any other facts that will help the court in passing on reorganization plans. The Securities and Exchange Commission is empowered to prepare advisory reports on reorganization plans for the use of the court. Creditors and stockholders may propose reorganization plans of their own and may compel the furnishing of data on which to base a program of action. Compensation, fees and expenses are stringently regulated. No person, without the consent of the court, may solicit the acceptance of any plan of reorganization until after the court or judge has approved the plan.

Present framework and procedure for corporate reorganization. The framework and procedure for corporate reorganization under the present Bankruptcy Act, briefly stated, are as follows:

(1) The jurisdiction and powers of the court during the pendency of the proceeding are the same, substantially, as those in an ordinary bankruptcy proceeding.

(2) Proceedings are instituted by the filing of a petition.

The petition may be controverted by an answer; but whether contro-

verted or not, the petition must be passed upon by the Court, who may approve or dismiss it.

(3) Upon approval of the petition, creditors and stockholders file their proofs of claim or interests in the manner and within the time fixed by the judge.

(4) Upon approving the petition, the judge must arrange for intermediate possession, custody and management of the corporate debtor's business, either by appointing a trustee or trustees, or by allowing the debtor to remain in possession subject to specified safeguards and court supervision.

(5) A plan of reorganization is then formulated and filed, which must contain certain provisions, and may contain others, tending to insure a fair, equitable and feasible program of adjustment.

(6) Hearings are then held on the plan, with a view to court approval; and the judge approves the plan or plans which in his opinion comply with the requirements of the Act, and are fair, equitable and feasible.

(7) The plan or plans approved are then submitted for acceptance by creditors and stockholders.

(8) Upon acceptance, the plan must be confirmed by the Court.

(9) Upon confirmation, the plan is consummated by the liquidations and distributions called for under the plan.

(10) If a plan fails of formulation, approval, acceptance, confirmation or consummation, the judge dismisses the petition, adjudicates the debtor a bankrupt, or directs the bankruptcy proceeding to continue, if it was pending when the reorganization proceedings were instituted.

Plan of reorganization: by whom formulated. When a trustee has been appointed, the judge fixes a time within which the trustee must prepare and file a plan, or report his reasons why a plan cannot be effected. When the debtor has been continued in possession, a plan or plans may be filed within a time fixed by the judge, (1) by the debtor, (2) by any creditor or indenture trustee, (3) by any stockholder (if the debtor is found to be solvent), or (4) by a disinterested person as examiner appointed by the judge to prepare such plan and to perform duties otherwise imposed upon the trustee.

Plan of reorganization: mandatory provisions. Among the mandatory provisions of a plan of reorganization are the following:

(1) *Modification in rights of creditors.* The plan must include, as to creditors generally or as to some class of them, secured or unsecured, provisions altering or modifying their rights, either through the issuance of new securities, or otherwise.

(2) *Costs and administration expenses.* The plan must provide for the payment of all costs, administration expenses and other allowances approved by the court.

(3) *Claims to be paid in cash.* The plan must specify what claims, if any, are to be paid in cash in full.

(4) *Creditors and stockholders not affected by plan.* The plan must specify the creditors or stockholders, or any class of them, not to be affected by the plan, and the provisions, if any, with respect to them.

(5) *Creditors who do not accept plan.* The plan must provide for any class of creditors which is affected by, but does not accept the plan by the two-thirds vote required by the act.

(6) *Stockholders who do not accept plan.* Except when the judge determines that the debtor is insolvent, the plan must provide for any class of stockholders which is affected by, but does not accept the plan by the majority vote required by the act.

(7) *Execution of plan.* The plan must provide adequate means for its execution.

(8) *Directors, officers or voting trustees.* The plan must include equitable provisions consistent with public policy for the manner of selecting directors, officers or voting trustees, if any, upon the consummation of the plan, and for the selection of their successors.

(9) *Rights of new stockholders.* The plan must provide for inclusion in the charter of the debtor or other corporation organized to carry out the plan, of provisions safeguarding the rights and privileges of stockholders.

(10) *Claims belonging to debtor.* The plan must provide, as to claims belonging to the debtor or to the estate which are not settled or adjusted in the plan, that such claims be retained and enforced by the trustee, or, if the debtor has been continued in possession, by the disinterested examiner appointed for that purpose.

K. Arrangements

1352. Definition and purpose: extension of debtor relief. An "arrangement" is defined by the Bankruptcy Act as "any plan of a debtor for the settlement, satisfaction, or extension of the time of payment of his unsecured debts, upon any terms." The provisions for arrangements embodied in the present Bankruptcy Act are an outgrowth of emergency relief provisions adopted by Congress in 1933, whereby debtors were given an opportunity to work their way out of their financial difficulties without the stigma of bankruptcy, by judicially controlled composition or extension agreements. Chapter XI of the act is designed for ordinary debtors, Chapter XII for real property arrangements, and Chapter XIII for wage earners' plans.

1353. Compositions, arrangements and common-law settlements, distinguished. Arrangements are really an outgrowth of compositions in bankruptcy, which were formerly provided for in section 12 of the Bankruptcy Act. The basic purpose of an arrangement is the same as that which governed compositions under the old act: to effect a compromise with unsecured creditors by offering them a settlement which would

yield them as much benefit as a full proceeding in bankruptcy without, however, the delays and expense of such proceeding; and at the same time to enable the debtor, freed from his financial burdens, to resume his normal status and activities.

A common-law settlement is one effected by contract between a debtor and his creditors. It offers the advantage of simplicity and freedom from the taint of bankruptcy. However, common-law settlements have always labored under a fundamental handicap: the power of a minority, or even one creditor, to block a full settlement. Compositions in bankruptcy under the old act and arrangements under the present act were designed to overcome this handicap. By a composition in bankruptcy, a willing majority had power to override a rebellious minority; and this advantage has been carried over into the provisions for arrangements under the present act.

Arrangements, however, offer an important advantage over compositions, which they have superseded. Although compositions in bankruptcy could be effected either before or after adjudication, they had to be consummated within the framework of the bankruptcy court. An arrangement, on the other hand, may be effected either during the course of a bankruptcy proceeding, or without any proceeding in bankruptcy at all.

1354. Who may take advantage of arrangements. Any person who can become a bankrupt may file a petition for an arrangement. This includes individuals, partnerships and corporations.

Insolvency as basis for arrangement. A debtor, to seek an arrangement, need not be "insolvent" under the definition of the Bankruptcy Act (excess of liabilities over assets). Insolvency in the equity or state meaning of the term (inability to pay debts as they mature) is sufficient.

Questions and Problems for Review

1. What is the object of the bankruptcy law? *AI Nov. 1922 (12)*
2. What is the distinction between insolvency laws and bankruptcy laws? *AI May 1930 (6)*
3. Define and distinguish insolvency at common law and under the Federal Bankruptcy Act. *AI Nov. 1919 (10)*
4. Distinguish between the duties of a referee in bankruptcy and the duties of a trustee in bankruptcy. *NY May 1926 (8)*
5. What authority has a referee in bankruptcy (a) to commit

for contempt, (b) to grant a discharge in bankruptcy, (c) to confirm a composition settlement? * *NY Nov. 1929 (6)*

6. (a). What is meant by the term *voluntary bankrupt*?

(b) Who may become a voluntary bankrupt? *AI Nov. 1921 (12)*

7. Who may take advantage of the Bankruptcy Act voluntarily, and who may be forced into involuntary bankruptcy? *AI Nov. 1917 (5); NY Nov. 1932 (5)*

8. A corporation bankrupt has assets converted into cash by the trustee amounting to \$285,000. There is outstanding \$100,000 of common stock, \$50,000 of preferred stock. Corporate bonds total \$75,000, taxes owing amount to \$8000 and claims of creditors aggregate \$150,000. How will the cash be distributed? *AI Nov. 1925 (II-2)*

9. X, stockbroker, is insolvent but refuses to make an assignment for the benefit of his creditors, or to take any other action. Is there any way by which his creditors can bring about a distribution of X's assets pro rata between them? *AI Nov. 1928 (11)*

10. Several creditors of the Municipal Street Railway filed against such railway in the United States Court on involuntary petition in bankruptcy. This petition set forth that the said railway was insolvent within the meaning of the National Bankruptcy Act and had made a written statement through its officers, that it was unable to pay its debts and was willing to be adjudicated a bankrupt on that ground. This petition was opposed by the railway company at the insistence of a committee of the stockholders on the ground that such a corporation could not be forced into involuntary bankruptcy under the Bankruptcy Act. State how this proceeding should be decided. Give reasons. *NY May 1926 (9)*

11. B, a son, takes out administration papers for his father's estate. As the claims come in, it is apparent that the estate is insolvent. Can the creditors force it into bankruptcy? Give reasons. *NY Jan. 1916 (1)*

12. (a) What is meant by an act of bankruptcy?

(b) Name the various acts of bankruptcy.

(c) What is a referee in bankruptcy, how does he obtain his position as referee, and what in general are his duties?

(d) What is a trustee in bankruptcy, how does he obtain his position as trustee, and what in general are his duties?

(e) What debts, if any, are not affected by a discharge in bankruptcy? *AI Nov. 1931 (10)*

13. Mention the principal acts which constitute acts of bankruptcy. *AI Nov. 1917 (6)*

14. Name three "acts of bankruptcy," the commission of any one

* Obsolete. See section 1353.

of which by an insolvent person furnishes grounds for the filing of a petition in bankruptcy. *AI May 1921 (12)*

15. A petition in bankruptcy is filed and granted against a partnership. The trustee demands a statement of the individual assets of the partners outside of their firm assets. There being no petition against the individual members of the partnership, has the trustee a right to demand such a statement? Give reasons. *NY Jan. 1916 (3)*

16. Explain what is meant by "receiver in bankruptcy" and "trustee in bankruptcy," and state how and by whom each may be appointed. *AI May 1920 (12)*

17. What are the principal duties of a bankrupt under the Bankruptcy Law? *AI Nov. 1923 (12)*

18. What are the duties of a trustee in bankruptcy? *NY Nov. 1929 (1)*

19. Frank Gordon owned a certificate of 100 shares of Union Pacific Railroad Company stock and realizing that his financial status indicated an early assignment, had the stock transferred to the name of his son James, to whom he gave it outright.

James Gordon borrowed \$5000 at the bank for his personal use, pledging this stock as collateral to the loan. Later, but prior to the repayment of the loan, Frank Gordon made an assignment to a trustee in bankruptcy. The trustee in bankruptcy demanded the return of the stock, upon the ground that the bank knew at the time of accepting the stock as collateral that it had been delivered to the holder by his father as a gift, that the father was insolvent at the time the transaction was made and therefore such transfer constituted a fraud upon his creditors. Has the bank any title to the stock as against the trustee in bankruptcy? State your reasons fully. *NY June 1922 (3)*

20. Richard Roe, a depositor in the First National Bank of Woodville, becomes insolvent. Just prior thereto the balance of his account in the bank amounted to \$1500. At the same time the bank held Roe's note for \$2000, which had been discounted. In contemplation of filing a petition in bankruptcy, Roe gave the bank his check for \$1500 to apply against his note, held by the bank. The trustee in bankruptcy subsequently brought suit against the bank, in an effort to compel the bank to turn over to him the \$1500 in Roe's account, on the ground that the acceptance by the bank of Roe's check just prior to filing his petition in bankruptcy constituted a preferential payment. Did the bank by so accepting Roe's check, waive its right to apply the \$1500 against Roe's note? Give reasons. *NY June 1924 (9)*

21. Robert Green is a depositor in the Third National Bank. In the regular course of business he discounts his six-month note for \$2000. Three months later he dies insolvent. Can the bank retain

the balance of Green's deposit account and apply it against the note which has not yet matured? *NY Jan. 1923 (2)*

22. *A* borrowed \$1000 from *B* Bank, which, instead of paying out to him the entire sum, at once placed the amount to his credit. *A* drew against that credit to the extent of \$400. Later *A* failed and the bank claimed for itself the balance of \$600. The creditors of *A* insisted that the bank should turn this \$600 over to the trustee. Whose contention is right and why? *NY Jan. 1916 (2)*

23. The Jones Company went into bankruptcy. The trustee went into possession and proceeded to liquidate. A year later the Federal internal revenue department claimed a large portion of the assets in the trustee's hands, for the payment of additional income tax assessed, found due on the audit of previous tax returns. The trustee resisted payment on the ground that claim had not been filed within one year as required by the Bankruptcy Act and was therefore barred. Was the trustee correct? *AI May 1924 (12)*

24. *A* presents a claim against a bankrupt estate within one year after the adjudication but subsequent to the distribution of a dividend. Can he share in the dividend? What if the final dividend has been declared and the estate closed? *NY Jan. 1916 (7)*

25. *A* has an unsecured note given by *B*, which is due three years from date. Six months after making the note *B* goes into bankruptcy. May *A* prove his claim? Can he ignore the proceedings and when the note is due have judgment on the note (*B* has in the meantime been discharged)? *NY Jan. 1916 (4)*

26. A trustee in bankruptcy of a corporation refuses to recognize the validity of the claim of a creditor on a promissory note, on the ground that the note is usurious. Is the note good against the estate of the bankrupt? Explain. *NY Jan. 1917 (8)*

27. Explain and illustrate each of the following as used in the Bankruptcy Act: (a) preferred creditor, (b) secured creditor. *NY Nov. 1927 (10)*

28. On examining the books of the *Y* Corporation you find a judgment in favor of the corporation against *A* for \$1000.00 recovered on December 10, 1919. You also find that on July 16, 1920, *A* filed a voluntary petition in bankruptcy showing assets (both real and personal property) amounting to several thousand dollars, and liabilities consisting, in addition to the judgment, of amounts due on various promissory notes and open accounts. How would you treat the judgment in preparing a financial statement for the corporation? *AI Nov. 1920 (11)*

29. *A* commences a suit against *B* and obtains an attachment of *B*'s property. Thirty days thereafter *A* enters judgment. The next day a petition in bankruptcy is filed against *B*, and twenty days thereafter he is adjudged a bankrupt. What is the effect, if any, on *A*'s attachment and judgment? *AI Nov. 1919 (11)*

30. In case of bankruptcy, does a creditor who has obtained judgment secure any advantage? *AI May 1926 (13)*

31. A bankrupt firm owes a certified public accountant for work done immediately before its bankruptcy. In what class, under the Bankruptcy Law, does this claim belong? Give reasons. *NY June 1920 (12)*

32. *X* was a stockholder, a director and the general manager of *G* Grocery Co. *G* Grocery Co. was adjudicated a bankrupt, and *X* filed with the referee in bankruptcy his claim against *G* Grocery Co. for \$1400 salary due him as general manager. Is *X* entitled to preference in the payment of his claim? Give reasons. *NY Nov. 1928 (15)*

33. The firm of Jones & Walsh became bankrupt as of June 3, 1933. *X*, a certified public accountant, audited the books of this firm for the calendar year 1932, completing his work by January 15, 1933. His fee has not been paid.

What principle or principles should govern this accountant in filing his claim for services rendered? Why? *NY Oct. 1933 (8)*

34. The Black Company holds a note of the White Company in the amount of \$2500. This note is secured by collateral worth \$1800. The White Company goes into bankruptcy but is expected to pay forty cents on the dollar. How much is the note worth? *NY Apr. 1934 (11)*

35. The copartnership of Jones & Smith was declared bankrupt, and copartnership assets were administered by a duly elected trustee. Just prior to distribution of the final dividend to creditors, the internal revenue department filed proofs of claim against the individual partners for unpaid income tax for prior years, claiming rights to priority of payment under the income tax law provision that the bankruptcy court shall order payment of all taxes legally due and owing by the bankrupt to the United States before payment of dividends to creditors. Could the revenue department succeed in its claim? *AI Nov. 1927 (12)*

36. Burns and Sanford are partners, conducting a profitable business. Sanford, however, is so much of a spendthrift that he falls deeply in debt and is forced into bankruptcy by his creditors. What effect, if any, does this have on the partnership? *AI Nov. 1929 (8)*

37. How does a dividend paid by a corporation differ from a dividend paid by a trustee in bankruptcy? *NY Nov. 1926 (3)*

38. Mention two claims against a bankrupt that are not affected by his discharge in bankruptcy. *NY May 1928 (8)*

39. *A* filed a petition in voluntary bankruptcy, including in his schedules the following liabilities: \$500 on promissory note, \$250 personal taxes due to the State of New York, \$500 on a claim for rent, \$1000 for alimony due his wife, \$5000 on a judgment for per-

sonal injuries incurred through the negligence of A's agent in operating A's automobile, \$500 on a claim for damages for obtaining certain stock by false representations made by A. All the holders of these claims were duly notified of the bankruptcy proceedings but did not file proofs of claim. Subsequently A received a discharge in bankruptcy. Which, if any, of the debts listed were discharged? *AI May 1920 (13)*

40. Plaintiff entrusted securities to defendant, a stockbroker, for safekeeping. Plaintiff was not dealing on margin, and he was not indebted to defendant in any amount, and defendant charged plaintiff a reasonable fee for his custodianship. Plaintiff gave defendant no authority to hypothecate these securities, but defendant nevertheless pledged them as security for a loan. Defendant became bankrupt and the pledgee of the securities legally and in due form sold them. Plaintiff now sues the defendant for the value of the securities, and defendant pleads his discharge in bankruptcy as a defense. Discuss the validity of this defense on each of the following assumptions:

(a) Defendant hypothecated the securities wilfully and maliciously.

(b) Defendant hypothecated them through an innocent but mistaken belief that the securities belonged to defendant. *AI May 1934 (4)*

41. Will the discharge in bankruptcy of a surety on a bond release him from liability to his cosurety who has discharged the bond liability upon its accrual subsequent to the discharge? *AI Nov. 1925 (I-5)*

42. What is a "composition" in bankruptcy? * *AI Nov. 1922 (13)*

43. Define "composition settlement" as used in bankruptcy. How is it used? What is its purpose? * *NY May 1929 (7)*

44. Answer each of the following relating to composition agreements:*

(a) May there be a composition agreement prior to adjudication in bankruptcy?

(b) What percentage of creditors in amount and what percentage of creditors in number are necessary? *NY Nov. 1928 (6)*

General Review

1. What is the distinction between an executed and an executory contract? Does a real contract exist in the former? Define bilateral contract, unilateral contract. *NY June 1916 (1)*

2. A purchased goods from B on the understanding that B should take back any goods unsold at the end of the season. During the season the goods were destroyed by fire without fault of A. By

* Obsolete. See section 1353.

whom must the loss be sustained? Explain. *NY Jan. 1917 (3)*; *NY June 1920 (13)*

3. State all the legal requisites of a valid sale. *AI June 1917 (1)*

4. What is meant by cumulative voting for the election of directors? How is it accomplished? *NY June 1917 (2)*

5. Define or describe void, voidable and unenforceable contracts. *AI June 1917 (3)*

6. Name six requisites to a valid contract. *NY June 1917 (8)*; *NY June 1920 (2)*; similar questions in *AI Nov. 1925 (II-1)*; *NY Nov. 1926 (2)*; and *NY Nov. 1934 (4)*.

7. What is meant by cumulative voting? Describe and state when it is frequently practised. *AI Nov. 1917 (10)*

8. Under what circumstances may a director incur a personal liability in respect of dividends paid by a corporation? *AI June 1917 (11)*

9. Name four instruments that are negotiable. *NY June 1917 (12)*

10. A, B, and C respectively contribute ten, eight, and six thousand dollars to the capital of a partnership. How should the resulting losses and gains be distributed in the absence of any agreement as to their distribution? *AI Nov. 1917 (13)*

11. What is a corporation? *NY June 1917 (14)*

12. Name four kinds of contracts that are required to be in writing under the statute of frauds. *NY Jan. 1918 (2)*

13. What is the implied contract of an indorser (a) as to accommodation paper, (b) as an indorser for value? *NY Jan. 1918 (4)*

14. What events operate as a dissolution of partnership? *NY Jan. 1918 (6)*

15. Give the substance of the New York Statute providing for the rendering of financial statements by a corporation to its stockholders. *NY Jan. 1918 (10)*

16. James Smith owned certain bonds payable to bearer, also certificates of stock in a corporation, which had been indorsed by him in blank. In going to the safe deposit vault to put the securities away he was knocked down by a streetcar and became unconscious, dropping the securities in the street. The finder sold the bonds and stock to Peter Jones. Jones acted in good faith in purchasing the securities, without knowledge of Smith's loss. What interest does Jones acquire in the securities? *NY Jan. 1918 (13)*

17. X owns several coalyards and puts Y in charge of one of them with instructions to hire only ten men. Y hires fifteen men. Is X liable for the wages of the five extra men? Explain. *NY Jan. 1918 (15)*

18. Define statute of limitations and state the theory underlying the statute. *NY June 1918 (1)*; *NY Jan. 1922 (8)*

19. Define guaranty. *NY June 1918 (2)*

20. What is an implied contract? *NY June 1918 (3)*

21. State (a) how a New York business corporation may be created, (b) how shares of a corporation are issued and transferred, (c) the liability of stockholders, (d) through whom a corporation acts, (e) doctrine of ultra vires, (f) how a corporation may be dissolved. *NY June 1918 (7)*

22. When, under a will, a fund is to be invested and the income applied to the use of a beneficiary for life, does the profit on a sale of security held as an investment under this provision become income or capital? *NY June 1918 (8)*

23. What are "fixtures" in the eyes of the law (a) as between the vendor and the vendee of real estate, (b) as between landlord and tenant? *NY June 1918 (13)*

24. What is the right of stoppage in transitu of goods, wares and merchandise by the seller? *AI Nov. 1918 (Contr 1)*

25. Has a stockholder a right to examine the books of a corporation? If so, for what purpose? *AI Nov. 1918 (Corp 3)*

26. State three cases in which the alteration of an executed and delivered note becomes material. *AI Nov. 1918 (Neg Instr 4)*

27. What is the law in relation to the hypothecation by a broker of securities belonging to a customer? *NY Jan. 1919 (7)*; *NY June 1920 (8)*

28. (a) What is a debt?

(b) When and where must payment be made and in what manner?

(c) On payment, can the debtor demand a receipt?

(d) If a debtor owes several amounts to a creditor, and makes a payment on account, without specifying the specific items to which the same is to be applied, what privilege has the creditor in the premises?

(e) In what manner is a partial payment of an interest-bearing debt applied?

(f) When does the statute of limitations begin to run? *NY Jan. 1919 (11)*

29. What does a person warrant who, for value, negotiated or transferred a document of title, by indorsement or delivery? *NY June 1919 (6)*

30. What is a deposit slip and what is its legal effect? *NY June 1919 (8)*

31. Jones, as trustee for a large estate, holds capital stock in various railroads. One of the roads determines to increase its capital

stock and notifies stockholders of record, of the terms upon which they may subscribe for new stock. The trustee decides not to subscribe and sells his rights for \$100. Does this \$100 belong to the life tenant or to the remainderman? *NY June 1919 (12)*

32. What are the rights of a vendor of personal property when the vendee wrongfully refuses to accept delivery thereof? *AI Nov. 1919 (7)*

33. Is a new member of a partnership responsible for the debts of the old firm? Explain. *NY Jan. 1920 (8)*

34. Has a stockbroker the right to sell stock bought by him for a customer on margin, to reimburse himself for advances made to the customer? Give reasons. *NY Jan. 1920 (9)*; *NY Jan. 1921 (15)*; *NY Jan. 1924 (14)*

35. Define dower. To what does this claim of dower usually extend? *NY Jan. 1920 (14)*

36. State six essentials of a (negotiable)* promissory note. *NY June 1920 (3)*

37. What is the law in New York State respecting the investment of trust funds by fiduciaries? *NY Jan. 1921 (4)*; *NY Jan. 1925 (4)*

38. Baker drew his check to Smith in payment of merchandise purchased. Smith, in order to obtain an additional amount of money, raised the check after it had been certified. He then induced Jones to cash the check at the increased amount. Has the bank any right to recover against Jones? Explain. *NY Jan. 1921 (9)*

39. What are the liabilities of a person who negotiates an instrument (a) by delivery, (b) by indorsement without qualification? *AI May 1921 (3)*

40. Simpson owned "bearer bonds" and certificates of stock of a corporation. The certificates were indorsed by him in blank. He lost the securities in a railway accident. The finder sold the bonds and the stock to Westfall. Westfall acted in good faith and without knowledge of the facts relating to the loss by Simpson. What interest does Westfall acquire in the securities? *NY June 1921 (14)*

41. What is the effect when a holder of a cheque procures its certification by the bank on which it is drawn? *AI Nov. 1921 (3)*

42. *E*, a miller, purchased from *G*, 500 bushels of wheat and ordered the grain shipped by rail. At the time of placing the order *E* gave *G* a draft for the agreed price of the wheat. *G* indorsed and deposited the draft in his bank, receiving unqualified credit therefor. *E* paid the draft when presented but immediately attached the proceeds in the hands of the bank, in his suit against *G*, basing his action on the ground that the shipment was fifty bushels short. The bank claimed that it was entitled to the full proceeds of the

* The word "negotiable" not in original.

draft, on the ground that having given *G* unqualified credit therefor, its title was in no way affected by the alleged breach of contract between *E* and *G*. Is the bank's claim valid? Give reasons. *NY Jan. 1922 (4)*

43. State fully what is an insurable interest in property. *NY Jan. 1922 (7)*

44. When, under a will, certain funds and securities are directed to be set aside to create a trust, the income of which is to be applied to the uses and benefits of a relative during his life, is the profit on a sale of any such security income or corpus? *NY Jan. 1922 (15); NY Jan. 1925 (8)*

45. To what requirements must an instrument conform to render it negotiable? *AI May 1922 (1)*

46. Define (a) a bailment, (b) a conditional sale. *AI May 1922 (5)*

47. Is there any distinction between the "capital" and the "capital stock" of a corporation, and if so, explain such distinction. *AI May 1922 (11)*

48. What is the difference between a receiver in bankruptcy and a trustee in bankruptcy? *AI May 1922 (12); AI May 1925 (12)*

49. What act, or circumstances, will constitute a legal break in the continuity of an account current after the usual business transactions have ceased? *NY June 1922 (9)*

50. Define (a) interest, (b) compound interest, (c) usury. *NY June 1922 (12)*

51. State the difference between a bailee and a del credere broker. *NY June 1922 (14)*

52. Richard Roe, merchant in Newark, N. J., received a draft from his customer in Missouri in payment of an account. Roe deposited the draft in the Uptown Bank in Newark. This bank in turn forwarded it to a correspondent in Kansas City for collection. The Kansas City bank collected the money and in transmitting it sent its draft on the Downtown Trust Company in Newark. The latter bank failed before the draft could be collected. Can Roe recover from the Uptown Bank for the amount of the draft? *NY Jan. 1923 (3)*

53. A check for \$9 drawn by Brown on the Downtown Bank in Boston was delivered to Gray who raised it to \$1900 and indorsed it in blank to the Riverside Bank in Pennsylvania with a request to collect it. The Riverside Bank indorsed it to the order of its Boston correspondent, the Chatham Bank "for collection for account of Riverside Bank," and the Chatham Bank received it and presented it to the Downtown Bank through the Clearing House. The Downtown Bank paid it by mistake as a check for \$1900, and the Chatham Bank turned over the proceeds to the Riverside Bank, which

in turn paid out \$1900 to Gray, who then fled to parts unknown. Whereafter the Downtown Bank discovered the alteration. What are the Downtown Bank's rights against (a) the Riverside Bank, (b) the Chatham Bank? *NY June 1923 (11)*

54. Name three ways by which a corporation may be dissolved. *AI May 1924 (10)*

55. A stockholder of an insolvent bank is also a creditor of the bank. Can he offset his creditor's claim against his statutory liability as stockholder? Explain. *NY June 1924 (12)*

56. Specify three acts of bankruptcy. *NY June 1924 (13)*

57. When should a draft be presented to the drawee for acceptance or payment? *AI Nov. 1924 (4)*

58. Explain the meaning of the words "ultra vires" as applied to corporations, illustrating by an example, actual or fictitious. *AI Nov. 1924 (10)*

59. In what circumstances, if at all, has a corporation power to purchase its own stock? *AI Nov. 1924 (11)*

60. Outline briefly the principal steps in a bankruptcy proceeding. *AI Nov. 1924 (12)*

61. (a) Describe a negotiable promissory note. (b) Draw a joint and several negotiable note. (c) At what place must a note be presented, if no particular place for payment is named therein? (d) Where must notice of dishonor be sent? *NY Jan. 1925 (10)*

62. You are the holder of a negotiable promissory note endorsed in blank by John Jones. How would you transfer the note so as not to become liable as a party to it, as a guarantor of its genuineness or as to prior parties? *AI May 1925 (4)*

63. In what case and to what extent is a stockholder liable for the debts of a corporation? *NY May 1925 (6)*

64. What are personal defenses to a negotiable instrument? What are absolute defenses? To whom are these defenses available? *AI Nov. 1925 (II-8)*

65. Explain the following: bill of sale, statute of frauds, stoppage in transitu. *AI Nov. 1925 (II-9)*

66. What is the cumulative system of voting by stockholders and what are its advantages? *AI Nov. 1925 (II-10)*

67. Define each of the following: (a) emblements, (b) agency, (c) devise, (d) gift, (e) express warranty. *NY Jan. 1926 (5)*

68. State when the title to goods passes in the following cases, if there is no agreement otherwise stated in the contract of sale: (a) goods sold C.O.D., (b) goods sold f.o.b. New York, (c) goods sold "on sale or return," (d) goods sold "on approval." *NY Jan. 1926 (7)*

69. What is the purpose of the National Bankruptcy Act? Who may become a bankrupt? From what debts does a discharge in bankruptcy release the debtor? Distinguish between bankruptcy and insolvency. *NY Jan. 1926 (9)*

70. What are the requirements of a negotiable instrument? What constitutes a material alteration of a negotiable instrument and what is its effect? *NY Jan. 1926 (10)*

71. State (a) two kinds of contracts required by the statute of frauds to be in writing, (b) two kinds of contracts that do not come within the provisions of the statute of frauds. *NY Jan. 1926 (14)*; also similar question *NY Nov. 1927 (7)*; *NY May 1930 (7)*

72. Explain and illustrate the term *valuable consideration* as used in the law of contracts. *NY May 1926 (1)*

73. Does a dividend on stock, declared before the stockholder's death, but not payable until a date after the date of death, become part of the estate or pass to the person to whom the stockholder devised the income from the estate for life? *AI May 1926 (5)*

74. Define the following used with reference to corporations: (1) subscriber, (2) incorporator, (3) franchise, (4) paid-in capital, (5) bylaws. *AI May 1926 (6)*

75. State the number and the qualifications of the directors in a national bank. State the liability of the stockholders in a national bank for the liabilities of the bank, if such bank becomes insolvent. *NY May 1926 (15)*

76. How may a seller part with possession of personal property and still keep title to it? *AI May 1926 (10)*

77. Define tender; accord and satisfaction; arbitration and award. *NY Nov. 1926 (1)*

78. State the order in which the liabilities of a partnership should be paid upon voluntary dissolution. *NY Nov. 1926 (4)*

79. State the difference between (a) an estate in fee and a life estate, (b) a bailment and a sale, (c) a guaranty and a warranty, (d) a mortgage and a trust deed. *NY May 1927 (2)*

80. State the essential elements that must exist in order to create a partnership. *NY May 1927 (4)*

81. State three ways by which a business corporation may be dissolved. *NY May 1927 (8)*

82. What is a corporation *de facto*? a corporation *de jure*? *AI May 1927 (10)*

83. Outline what is meant by the rediscounting of commercial paper by a Federal Reserve bank. State (a) how a Federal Reserve bank note is secured, (b) how a Federal Reserve note is secured. *NY May 1927 (11)*

84. Name four kinds of indorsements that may be made on a negotiable instrument. Does an indorsement "without recourse" relieve the person so indorsing from all liability on the instrument? *NY May 1927 (13)*

85. Distinguish between a foreign bill of exchange and an inland bill of exchange. State when protest is absolutely required by law in order to hold the parties secondarily liable on a negotiable instrument. *NY May 1927 (14)*

86. Define and illustrate: (a) parol contract, (b) next of kin. *NY Nov. 1927 (1)*

87. What are "fungible goods"? Illustrate. *NY Nov. 1927 (3); NY May 1930 (3)*

88. Illustrate each of the following: (a) estate in severalty, (b) residuary devisee, (c) allonge. *NY Nov. 1927 (5)*

89. Is it necessary that a promissory note contain the words "for value received" or other words expressing consideration in order that the note be negotiable? *AI May 1928 (1)*

90. Define (a) particular estate, (b) mutuum. *NY May 1928 (1); NY May 1930 (1)*

91. Explain and illustrate (a) particular lien, (b) charging lien. *NY May 1928 (7)*

92. (a) What is a cumulative dividend?

(b) What is a *de facto* corporation?

(c) What is a *de jure* corporation? *AI May 1928 (8)*

93. Give an illustration of each of the following: estoppel by judicial record, executory consideration. *NY May 1928 (10); NY May 1930 (10)*

94. Distinguish between a partnership, a joint stock association and a corporation. *AI Nov. 1928 (4)*

95. Give an illustration of each of the following: (a) del credere agent, (b) secured creditor. *NY May 1929 (3)*

96. Distinguish between the partnership capital contribution of a "general partner" and that of a "special partner." *NY May 1929 (5)*

97. Explain what is meant by each of the following: act of bankruptcy, voluntary bankruptcy, involuntary bankruptcy, composition. *AI May 1929 (13)*

98. Define and explain the following terms or expressions relative to contracts: special damages, liquidated damages, legal tender, substantial performance. *AI Nov. 1929 (1)*

99. When is a person insolvent under the Bankruptcy Act? What constitutes an act of bankruptcy? *NY Nov. 1930 (1)*

100. Is a depositor with a checking account in a bank under obligation to verify the correctness of the balance shown by his monthly statement? Explain fully. *NY Nov. 1930 (7)*

101. Name the four essential elements of a binding contract. *NY May 1931 (1)*

102. Define (a) the statute of frauds, (b) the statute of limitations. *NY May 1931 (2)*

103. (a) What is the common method by which a corporation elects its board of directors and its officers? (b) How many votes has each stockholder? (c) What is a "proxy to vote"? *NY Nov. 1931 (1)*

104. What are the important differences in the law relating to consideration as applied to negotiable instruments and other contracts? *NY Nov. 1931 (2)*

105. What is the difference between a sale and a contract to sell? *NY Nov. 1931 (9)*

106. (a) Define the word "foreign" as used in the phrase "foreign corporation." Give an example of a foreign corporation.

(b) Define and give an example of a *de facto* corporation.

(c) Can a corporation commit a crime? If so, give an example.

(d) Can a corporation commit a tort? If so, give an example. *AI May 1932 (1)*

107. (a) Define and give an example of personal property.

(b) Define and give an example of a pledge.

(c) Is transfer of possession essential to a pledge?

(d) What in general are the remedies of a pledgee upon the pledgor's default? *AI May 1932 (11)*

108. Differentiate common law, statute law and business law. Define (a) contract, (b) tort. *NY June 1932 (1)*

109. What are the two main advantages of the corporate form of business organization? By what authority are corporations created? *NY June 1932 (4)*

110. Define usury and state the penalty for usury. Mention *three* exemptions from the operation of the usury law. *NY June 1932 (7)*

111. Define the following: (a) duress, (b) friendly fire, (c) bulk sales, (d) marshaling assets, (e) delivery in escrow. *NY Nov. 1932 (1)*

112. What usual powers has a bank? In relation to what matters has a bank generally no authority? *NY Nov. 1932 (9)*

113. Contrast "insurable interest" with relation to life insurance and with relation to property-damage insurance. Of what must such interest consist? *NY Nov. 1932 (11)*

114. Define the following: (a) guardian by deed, (b) power (in

real property law), (c) law of the land, (d) ostensible partner, (e) cumulative voting rights. *NY Apr. 1933 (1)*

115. What constitutes a material alteration of a negotiable instrument? *NY Apr. 1933 (2)*

116. Enumerate the types or classes of commercial paper that are or may be excluded from eligibility for rediscount by a Federal Reserve Bank. *NY Oct. 1933 (7)*

117. The *X* Company closes out its current account with the *A* Trust Company while it has time notes at such bank under discount. The *A* Trust Company requests the *X* Company to take up these notes. Is the *X* Company compelled to do so? *NY Oct. 1933 (10)*

118. A depositor in the Amalgamated Bank sued the bank to recover the amount paid by the bank upon the forged endorsement of the payee of a cheque drawn by the depositor. At the time the cheque was given to the payee, the latter gave the depositor a promissory note payable on demand for the amount of the cheque. The bank pleaded as a defense that the depositor had been negligent in not making a timely demand upon the payee of the cheque for the payment of the note. Is this a good defense? *AI Nov. 1933 (10)*

119. Debtor *A* owes his creditor *X* a number of separate obligations, incurred at different times, which total \$1800. Debtor *A* sends *X* a check for \$1000.

(a) What principles govern creditor *X* in applying this check to the obligations owed him by *A*?

(b) One of the debts owed has been barred by the statute of limitations. Part of the payment received is applied in partial payment of this debt. What principles govern the right of *X* to sue for the balance still owed on the debt barred? *NY Apr. 1934 (9)*

120. A savings bank received a letter purporting to be signed by one of its depositors and enclosing that depositor's passbook. The letter contained a request that a cheque for part of the balance of the account be mailed to him at an address in another state. The bank as requested mailed the cheque and the passbook, enclosing them with a letter addressed to the depositor. The cheque was presented to the drawee national bank by the writer of the first letter, and he identified himself by showing the depositor's passbook and the letter written by the savings bank. The national bank paid the cheque. Subsequently the savings bank learned that its depositor's passbook had been stolen and that the letter purporting to be from him was a forgery. Can the savings bank recover the amount of the cheque from the national bank? *AI May 1934 (2)*

121. Define briefly the following terms (do not discuss or give example)

(a) last will and testament

(b) legacy

(c) testamentary trustee

(d) principal of trust

(e) life tenant

(f) remainderman

AI May 1934 (10)

122. (a) Define and differentiate condition precedent and condition subsequent.

(b) Define and differentiate representation and warranty. *AI May 1934 (11)*

123. What constitutes negotiation? Mention *two* characteristics that distinguish negotiable instruments from an ordinary contract. Name *four* kinds of negotiable instruments. *NY Nov. 1934 (1)*

124. Explain *each* of the following: (a) caveat venditor, (b) estoppel, (c) composition, (d) deed, (e) safekeeping. *NY Nov. 1934 (14)*

125. What is a limited partnership? *AI May 1922 (9)*

126. What elements must be present to constitute a novation? *NY Nov. 1932 (7)*

Part II

QUESTIONS and ANSWERS

CHAPTER I-A

Law in General

1355. AI Nov. 1935 (10). One of the maxims in equity is: "He who comes into equity must come with clean hands." State briefly the other principal maxims but do not elaborate upon or discuss them.

There are thirteen other well-known maxims in equity (set forth and explained in sec. 9).

1356. AI Nov. 1942 (5). Explain what is meant by marshaling of assets, and give a brief statement of facts illustrating a situation in which this doctrine should be applied.

When one claimant has two funds to which he may resort to answer his demand, and another claimant has an interest in only one of the funds, the latter can compel the former to take satisfaction out of the fund in which the second claimant has no lien. For a statement of facts illustrating a situation in which this doctrine should be applied, see section 10. The doctrine is frequently applied in apportioning partnership and individual assets among partnership and individual creditors upon dissolution of the firm (sec. 708).

1357. AI Nov. 1936 (4). It is a rule applied by courts that "where one claimant has two funds to which he may resort to answer his demand, and another claimant has an interest in only one of such funds, he (the latter) can compel the former to take satisfaction out of the fund in which the latter has no lien."

(a) Can this properly be classified as a rule of the common law?

(b) If not, how would you classify it?

(a) No.

(b) It is a rule of equity. See secs. 10 and 1356.

1358. NY Oct. 1943 (1). (a) Have you read the instructions preceding this question?

(b) Will you follow these instructions in your answers?

(c) Do you understand that failure to follow these instructions will result in lower ratings on your answers?

(d) Do you realize that the words you use in your answers will be deemed to carry their meanings in commercial law rather than the non-

technical meanings for which laymen may use them in conversation or correspondence?

(e) Compare or contrast the terms business law, law of business, commercial law, law merchant, which are used in some textbooks and in some statutes, or any others of which you know, stating your understanding of each; indicate whether any one is more widely inclusive than the others and explain why.

(f) How did the rules arise—by custom, by statute, by court decisions or otherwise?

(e) The terms *business law*, *law of business* and *commercial law* have in recent years come into general use to denote rules of law of primary concern to business and to the professions ministering to business. The study of commercial law normally excludes adjective law (sec. 3) and such noncommercial matters as international law, matrimonial rights and duties, and crimes or torts which have no relation to business.

The *law merchant* is that branch of the unwritten law which was originally founded on the customs of merchants, mariners and businessmen generally in their dealings with one another throughout the civilized countries of the world. In the course of time these customs were recognized and adopted by the common law and ultimately embodied in statutes such as the Negotiable Instruments Law.

(f) The rules of business law and of the law merchant, like most rules of law today, are based in part on custom or precedent expressed in judicial decisions, and in part on statutes many of which, in turn, are themselves based on custom reflected in judicial decisions (sec. 5).

1359. NY Apr. 1944 (8). Compare or distinguish the crimes of two cashiers each of whom stole \$300 from his corporation employer but under somewhat different circumstances, as follows:

(a) *A* took currency received by him as the proceeds of a note receivable which had never been entered on the corporation's books.

(b) *B* took currency from the cash drawer and made an entry charging the amount to an expense account on the corporation's books.

(You are not expected to be acquainted with all refinements of the Criminal Law, but accountants should have sufficient knowledge of it to make sure that counsel for their clients or employers are fully informed.)

A is guilty of larceny by embezzlement, but *B*, having made a false entry in connection therewith, is guilty not only of larceny by embezzlement but also of forgery in the third degree (sec. 46).

1360. NY Apr. 1941 (9). Understanding that public accountants are subject to the same penalties as other persons for crimes or misdemeanors committed by them, answer each of the following questions with brief explanations:

- (a) Is a certified public accountant subject to any further penalty?
- (b) Is there any provision of law in this state applying specifically to public accountants who are not C.P.A.'s?

(a) Legislation governing the practice of accountancy in the United States is far from uniform. In New York (this being a New York question), anyone who, without being certified, holds himself out as a certified public accountant engaged in the public practice of accountancy, or who uses the title "certified public accountant," or "C.P.A.," is guilty of a misdemeanor punishable by imprisonment for not more than one year, or by a fine of not more than \$500, or by both, for each separate offense. In addition, the attorney-general may recover a civil penalty from such person of \$100 for each offense, whether separate offenses are committed on the same day or not (sec. 44).

(b) New York has no provision applying specifically to public accountants who are not C.P.A.'s (sec. 44).

1361. NY Apr. 1938 (12). The so-called "false statement laws" provide that the making of a false financial statement for the purpose of obtaining credit and with intent that it shall be relied upon, is a misdemeanor punishable by fine and imprisonment. The crime is threefold and the law aims to punish the parties thereto. What *three* parties are punishable under the law?

The three classes of persons punishable under section 1293-b of the Penal Law of the State of New York for obtaining property or credit by the use of a false statement, are:

(1) A person who, to secure credit, *knowingly makes or causes to be made* a false written statement concerning the financial condition or ability to pay of himself or of some other person, firm or corporation in which he is interested or for whom he is acting.

(2) A person who, *knowing that such a statement has been made* concerning himself or some other person, firm or corporation in which he is interested or for whom he is acting, procures money, property or credit on the faith of such statement.

(3) A person who, knowing that a written statement has been made concerning the financial condition or ability to pay

of himself or some other person, firm or corporation in which he is interested or for whom he is acting, "*represents on a later day, either orally or in writing, that such statement theretofore¹ made, if then again made on said day, would be then true, when in fact, said statement if then made would be false,*" and who procures money, property or credit upon the faith of such oral or written statement.

1362. NY Oct. 1940 (7). Much has appeared in print lately about monopolies.

(a) What do you understand a monopoly to be?

(b) Name at least three acts now in effect to prevent monopolies.

(a) A monopoly, literally, is an exclusive privilege. It may be granted by a government to stimulate creative effort, as in the case of patents and copyrights (sec. 1068), or it may be achieved by restraining trade and concentrating it in the hands of a single individual or group, thereby threatening the public interest through control of supply and prices.

(b) Sherman Anti-Trust Act, Clayton Act and Robinson-Patman Act (sec. 55).

1363. NY Apr. 1938 (14). State briefly the nature of each of the following: (a) Robinson-Patman Act, (b) Tydings-Miller Act.

(a) The Robinson-Patman Act, enacted in 1936, was designed to strengthen and supplement the provisions of the Clayton Act dealing with price discrimination among competitive concerns. Recognizing the extraordinary advantage which large buyers have over small ones in securing price concessions, particularly during periods of financial depression, Congress framed the act in question so as to make it unlawful for any person engaged in interstate commerce either directly or indirectly to discriminate in price between purchasers of commodities of like grade and quality, where such discrimination might tend to create a monopoly in any line of commerce, "or to injure, destroy or prevent competition with any person who either grants or knowingly receives the benefit of such discrimination."

(b) The Tydings-Miller Bill, enacted in 1937, amended section 1 of the Sherman Anti-Trust Act by legalizing resale price maintenance contracts in interstate commerce where permitted by the states in which such contracts are to be enforced.

¹ The original statute, as reported in *McKinney's Consolidated Laws*, reads "therefore," but undoubtedly "theretofore" was intended.

1364. AI Nov. 1939 (9). (a) What is the name of the principle of law by which a state, or a subdivision of a state, is permitted to institute proceedings to obtain privately owned real property for a public purpose?

(b) Where such real property includes a building in which a tenant of the owner had installed and used factory machinery, in what circumstances must the damages awarded in the condemnation proceeding include the value of such machinery?

(a) The power of eminent domain (sec. 68).

(b) "A tenant whose leasehold interest is taken is usually entitled to compensation for his fixtures and the improvements made by him during the term, if the lease gives him the right to remove them, or if the lessor is to pay him for them, otherwise not." 29 *Corpus Juris Secundum* 1050-1051.²

1365. NY Oct. 1943 (15). (a) Define (1) garnishment, (2) garnishee.

(b) An envelope in an employer's cash drawer, containing a week's wages of an employee, is marked "garnisheed."

(1) To whom does this money belong?

(2) What action does the employer take in this matter?

(a) (1) Garnishment is a proceeding to satisfy a judgment out of moneys or property in the hands of a third party due and owing to the person against whom the judgment is procured. It consists in obtaining a court order and serving a copy of it upon the third party (for example, an employer) who owes moneys to the judgment debtor. The execution amounts to a command by the Court and an authorization to pay. Upon presentation, the execution constitutes a lien and continuing levy (sec. 73) upon all subsequent earnings of the judgment debtor until the debt is paid. "The word 'garnishee' is borrowed from the French language and is derived from 'garnishment,' or from the word 'garnir,' meaning to warn or give notice. Garnishment is correctly defined to be a proceeding in the nature of an attachment or execution, by means of which credits, property, or effects of the debtor in the hands of a third person may be subjected to the payment of the claims of creditors of such debtor."³

(2) "The garnishee is the custodian of the property or funds in his hands attached. He is not interested in the result. He simply follows the orders of the court."⁴

² Citing *People v. Ganahl Lumber Co.*, 10 Cal. 2d 501, 75 P. 2d 1067; *Cornell-Andrews Smelting Co. v. Boston & P.R. Corporation*, 209 Mass. 298, 95 N.E. 887; *U.S. v. 44,549 Square Feet of Land in Borough of Brooklyn, N.Y.*, D.C.N.Y., 45 F. Supp. 853.

³ *Coller v. Sheffield Farms Co.*, 129 Misc. 600, 223 N.Y. Supp. 305, 310.

⁴ *Collér v. Sheffield Farms Co.*, *supra*.

(b) (1) The moneys belong to the employee, subject to the lien and levy of the execution, and subject to the order of the Court that a stated percentage⁵ be paid over to the sheriff, marshal or constable toward satisfaction of the debt.

(2) The employer must pay over to the sheriff, marshal or constable who served the execution, the amount therein specified, until the execution is wholly satisfied.

1366. AI May 1936 (1). Parker, a certified public accountant, made an audit of Thornton's books of account and rendered a financial report which Thornton used in obtaining credit. Answer each of the following questions, giving legal arguments or reasons for each answer:

(a) If Thornton is sued by a creditor who had not seen Parker's report, can Parker, as a duly subpoenaed witness, decline to disclose business information procured by him during the conduct of his audit but not incorporated in his report?

(b) If Thornton is arrested and tried in a criminal proceeding, can Parker, as a duly subpoenaed witness, decline to disclose such information?

(c) Can Thornton compel Parker to turn over to him an analysis (in pencil) of an asset account made at Parker's request and for his assistance by Thornton's bookkeeper during the conduct of Parker's audit?

(d) Can Thornton compel Parker to turn over to him an analysis (in pencil) of the asset account referred to in question (c) made by one of Parker's assistants during the conduct of his audit?

(e) Can Parker by his last will and testament bequeath all of his working papers to a legatee?

(a) Parker could not decline to testify, except in a minority of states where disclosures to public accountants in their professional capacity constitute privileged communications (sec. 86).

(b) The answer is the same as in (a) above, unless such testimony tended to incriminate Parker, in which event he might plead his constitutional privilege (sec. 61, *Self incrimination*).

(c) (d) No, in both cases. An accountant's working papers are his own, whether written in pencil or in ink, and whether prepared by him personally or by assistants under his direction. Such assistants may be those in his regular employ, or supplied by the client.

(e) Not those involving confidential data. See sec. 1169.

1367. AI May 1943 (12). Johnson, a certified public accountant, is retained to testify in a court concerning the effect, on the rights of income

⁵ In this case, 10%, the question having been framed by the New York examiners.

bond holders, of credits to a reserve for sinking fund made by a corporation with the affairs of which he was completely unfamiliar. •

(a) What type or kind of testimony will he give?

(b) What is meant by "qualifying" him as a witness?

(c) How will the facts upon which he is to testify be made known to him?

(a) Johnson will give expert testimony.

(b) To qualify a witness is to disclose, by answers to questions propounded for this very purpose, that the witness is fit to testify as an expert (sec. 94).

(c) Expert opinion is based upon a "hypothetical question" (sec. 94), reflecting the facts which counsel assumes to have been proved on the trial.

1368. NY Oct. 1942 (5). (a) What is meant by privileged communications?

(b) Does the rule apply to the following communications?

(1) By a client to his attorney.

(2) By an employer to his bookkeeper.

(3) By a taxpayer to his C.P.A. auditor.

(4) By a patient to his physician.

(5) By a parishioner to his priest.

(6) By a citizen to an editor.

(a) Because of their peculiarly confidential relationships, certain parties are made incompetent by law to testify as to "privileged" communications between them.

(b) The rule applies in (1), (4) and (5) above, but not in (2) or (6), nor in most states to (3). (See secs. 85 and 86.)

1369. NY Apr. 1941 (10). (a) What is meant by the expression *privileged communication*?

(b) Answer yes or no (with explanation if you wish) as to its applicability to a statement made by an interested person to (1) his physician, (2) his attorney, (3) his attorney's clerk, (4) his attorney's interpreter, who was the medium for the communication, (5) his auditor, (6) his auditor's staff accountant.

(a) See secs. 85 and 1368.

(b) The rule applies in (1), (2), (3) and (4), but not in (5) and (6) in most states. (See secs. 85 and 86.)

1370. NY Oct. 1943 (9). *B*, who is in financial difficulties, goes to his friend, *A*, and asks for a loan of \$10,000, which *A* agrees to make and does make. *B*, fearing his credit may be impaired by publicity of the matter, asks *A* to keep the matter strictly secret and *A* does so. *B* gives *A* his promissory note for \$10,000, due in one year, but dies before the maturity of the note. *A*, on searching for the note, is unable to find it. The attorney for *A* asks your aid in finding any evidence that may help to prove the debt owed by *B* to *A*.

- (a) What sources of information would you investigate?
- (b) What records might be useful as evidence?

(a) The following sources are suggested:

- (1) A's cancelled check for \$10,000.
- (2) Bank record showing deposit of A's check in B's bank.
- (3) Books of B showing notes payable account.
- (4) Books of A showing notes receivable account.
- (5) Proof of lost note and its contents.

(b) All the above items of evidence would be admissible:

(1) is primary evidence (sec. 87), as the note would have been had it been available; (2) and (5) are secondary evidence (sec. 88); (3), as an admission against interest, would constitute an exception to the hearsay evidence rule (sec. 90); and (4) would be admissible under the shop book rule (sec. 91).

1371. NY Oct. 1937 (8). (a) What is a statute of limitations?

(b) What is its object?

(a) By the term *statute of limitations* is meant a statutory provision or collection of statutory provisions fixing a time limit within which suit may be brought on specified causes of action. If in any case suit is brought after the expiration of the period prescribed in that case, the action is said to be *barred* or *outlawed*.

(b) The object of statutes of limitation is to expedite the prosecution of legitimate causes of action and to discourage the bringing of stale claims. The theory underlying such statutes is that it is the general experience of mankind that claims which are valid are not usually allowed to remain neglected, and that a lapse of years, without any attempt to enforce a demand, creates a presumption against its original validity, or that it has ceased to exist. Furthermore, the negligence or laches of a plaintiff is advanced as an additional ground for barring him from enforcing his remedy. The basic principle on which such statutes are most generally justified, is that they tend to prevent fraudulent and stale claims from springing up at great distances of time and surprising parties or their representatives, when all the proper vouchers or evidences which might be introduced in defense of the claim, or the facts which might bear upon the claim, have become obscure. Under such circumstances, such factors as lapse of time, defective memory, death, or removal of witnesses might constitute serious impediments to justice.

1372. NY Oct. 1938 (14). (a) What is meant by the term *statute of limitations*?

(b) Give *two* examples.

(c) Are these statutes state or Federal laws?

(a) See sec. 1371.

(b) *Thirty-three* examples will be found in the chart on pages 46 and 47.

(c) These statutes may be state or Federal (sec. 97).

1373. NY Apr. 1936 (11). When does the statute of limitations begin to run on an open account? Mention some of the ways in which its operation may be modified.

The statute of limitations begins to run on an open account from the date of the last item of the account at the point where the continuity of the account has been broken and a final balance may be said to be due (sec. 98).

The statute may be modified (a) by suspension and (b) by tolling.

(a) The statute may be suspended by (1) disability of the plaintiff to sue (as in the case of infancy or insanity) and (2) absence of the defendant from the jurisdiction, so that he cannot be sued (sec. 99).

(b) The statute may be tolled by (1) written acknowledgment of the debt and (2) payment, either on account of principal or interest (sec. 100).

1374. NY Apr. 1937 (3). Suppose that you have recently become the comptroller of a Delaware corporation which has its head office at Providence, R.I., or that you have been engaged to make an independent audit of it. As such, you are asked to prepare a balance sheet for submission to its banks for loans. You find that it has a branch at Rochester, N.Y., which has on its books many large accounts receivable from New York State customers, which are overdue. The credit manager informs you that the debtors are financially responsible and credit-agency reports confirm his opinion.

(a) In considering the appropriate reserve for doubtful accounts, what would you wish to learn as to the practicability of enforcing collection?

(b) What sources of information would you investigate for that purpose?

(a) The practicability of enforcing collection, at least from the legal standpoint, would depend upon (1) whether the accounts were or were not outlawed by the statute of limitations, and (2) whether the Delaware corporation had filed a certificate authorizing it to do business in the State of New York.

(1) To determine whether or not the statute of limitations had run in any particular case, it would be necessary to age

the accounts. The limitations statute applicable would be the New York statute which, in case of debt, provides for a six-year period within which action must be commenced, starting with that point of time at which the creditor had a right to sue, namely, when the debt became due. It would therefore be necessary to determine the terms of payment of each of the accounts so as to ascertain how far the account is past due.

(2) In view of the fact that the Delaware corporation has a branch establishment at Rochester, N.Y., it would be classed, on all suits brought in the State of New York, as a foreign corporation doing business in the state. It would therefore be unable to sue in a New York State court for the recovery of any of its New York accounts receivable, unless it had filed a certificate authorizing it to do business in New York. See section 875. However, it could sue on such accounts in the Federal Court, provided the amount involved (at least \$3000) gave the Court jurisdiction.⁶ Therefore, not only would it be material to inquire whether the Delaware corporation filed a certificate authorizing it to do business in New York, but, in case it failed to file such certificate, it would be material to ascertain which of the accounts equalled or exceeded \$3000 to determine whether action could be brought in the Federal Court.

(b) With reference to the sources of information to be investigated:

(1) *As to the statute of limitations.* In order to establish the age of the accounts, the sources of information to be investigated would embrace: (i) information furnished by the credit manager and confirmed by credit agency reports; (ii) inquiry of credit manager's superior officer as to why suit had not been started in connection with accounts on which no action had been taken; (iii) the drawing of original reports from credit agencies; (iv) confirmation as to the validity of the accounts by direct correspondence with the debtors themselves, in which not only confirmation of the account itself should be sought, but an inquiry made as to the reasons why payment had not been made in view of the fact that the account was past due; (v) original data concerning the cases that had been forwarded to an attorney for collection.

(2) *As to the right to sue in New York.* Inquiry at the of-

⁶ *David Lupton's Sons Co. v. Automobile Club of America*, 225 U.S. 389.

fice of the Secretary of State at Albany would elicit the information as to whether or not a certificate had been filed by the Delaware corporation in compliance with section 210 of the New York General Corporation Law; whether a certificate of authority to do business had been duly issued pursuant to section 210 of said statute; and whether the necessary fee had been paid pursuant to section 181 of the New York Tax Law.

1375. NY Oct. 1940 (14). Smith owes Jones \$800 on a note, with interest at 4%. This indebtedness has continued for over six years. The debtor on the note has made semiannual interest payments by check and several of these checks bore the notation on the face of the checks "Int." or "Int. on note." Smith claims that the obligation is outlawed by the running of the statute of limitations.

(a) Does the notation on the face of the checks toll the running of the statute of limitations?

(b) Explain.

(a) The notations on the face of the checks do not, of themselves, toll the running of the statute.

(b) It is the fact of payment, not the making of a notation, that tolls the running of a statute; unless, of course, the notation is made by the debtor himself, in which event it will constitute proof (1) as an admission against interest (sec. 90), or (2) as a written acknowledgment by the debtor coupled with an inference that he promises to pay the balance (sec. 100). If such notations *by the creditor* were allowed to toll the statute, the way would be opened to fraudulent attempts to toll the statute by false entries.

1376. NY Oct. 1942 (3). (a) In ordinary conversations you may occasionally hear the word outlawed. What do you understand to be its meaning when so used?

(b) The word may be used in the consideration of over 30 different situations which an accountant may meet in his practice. Obviously it would not be safe for him to assume that he knew them all and to presume to apply the law to them from memory. But there are some situations in which an auditor should give consideration to the matter. State some general classes of such situations.

(a) The word "outlawed," in commercial law, is commonly used to denote the barring of legal claims by the lapse of time, as fixed by the statute of limitations. After such lapse, a claim is said to be outlawed—no longer entitled to legal protection.

(b) An auditor, in examining notes and accounts receivable, should check to see whether any of such items are outlawed by

the statute of limitations and consequently worthless as enforceable claims. (See sec. 1374 and the table on pages 44-45.) He should also consider tax returns in the light of their susceptibility to government revision or whether such revision is barred by the statute of limitations (sec. 97). He should note, further, any possible revivals of outlawed claims by payments on account or acknowledgments in writing, and the possibility, by such means, of reviving outlawed accounts (sec. 100). In writing off as bad, accounts which are outlawed, he will bear in mind that the statute is suspended under certain conditions (sec. 99).

1377. NY Apr. 1944 (7). (a) Discuss the possibility of reviving a debt barred by the statute of limitations.

(b) Does the date within which an action might have been brought by or against a person who died before that date still hold for or against his executor or legal representative?

(a) The debt may be revived by written acknowledgment or by payment of principal or interest. See secs. 100 and 1373.

(b) The death neither of a claimant, nor of a debtor, revives a cause of action outlawed prior to death. In some states the interval between death and the granting of letters (during which no suit is possible) is added to the statutory period. In New York (this being a New York question), if a claim becomes outlawed after the claimant's death but before the expiration of one year after death, the executor or administrator may bring suit notwithstanding, provided he does so before the year expires. When the person liable on a claim dies, a period of eighteen months after death may be added to the statutory period. Executors and administrators are not chargeable for estate assets and moneys distributed unless claims are presented within seven months after issuance of letters (within six months, where the executor or administrator publishes notice requiring claims to be filed by then). (See sec. 97.)

1378. AI May 1941 (2). X was legally indebted to Y, but Y had permitted the statute of limitations to run and his claim against X became barred on March 1, 1940. On April 22, 1940, X in writing voluntarily promised Y that X would pay the amount of this barred claim in ten days. X failed to pay and in an action by Y against him X pleaded that there had been no consideration for his promise of April 22, 1940. Is this plea by X a valid defense?

X's plea is not a valid defense. X's written promise created no new obligation; it merely waived the statutory bar to recovery upon a pre-existing obligation. Regardless of the theory underlying the rule which dispenses with consideration in such cases, many states specifically provide by statute that such written promise revives the debt, thereby making consideration immaterial. In some states (New York, for example), any written promise based on past consideration is binding.

1379. AI May 1942 (5). (a) What is a statute of limitations?

(b) What is its purpose?

(c) Is it or are they Federal or state laws or both?

(d) Is the limitation the same in all instances?

(e) Illustrate generally your answer to (d) above.

(f) Mention some instances in which the matter of limitation is of especial importance to accountants.

(a) See sec. 1371.

(b) See sec. 1371.

(c) Both. See sec. 97.

(d) The limitations vary with the type of action and the state having jurisdiction.

(e) See table on pages 44-45.

(f) See sec. 1376, subd. (b).

CHAPTER II-A

Contracts

1380. NY Oct. 1937 (2). Mention five elements of a contract, the absence of any one of which will render the document void.

It will be noted that this question refers to a *written* contract, since it relates to elements "the absence of any one of which will render the *document* void." The fundamental requisites of a contract are *four* in number:

1. Mutual assent (offer and acceptance).
2. Competent parties.
3. Consideration.
4. Valid subject matter.

To the above standard requisites of a contract is sometimes added the requisite of *form*; that is, that in certain cases (prescribed by the statute of frauds) the contract must be evidenced by a writing signed by the party to be charged. In the present case such an element was evidently not in the minds of the examiners because the question is premised on a contract already in writing.

Therefore, the element of *time* may be suggested as an additional essential requirement. Even when a contract does not specify time for performance, the law implies a reasonable time, so that time is an essential requisite in any event, and in some cases, is *of the essence* of a contract (sec. 215).

1381. NY Apr. 1938 (4). If an offer is made by mail, when is the offer completed? If an acceptance is to be made by mail, when is the acceptance completed? May either the offer or the acceptance be withdrawn? **Explain.**

An offer by mail is completed when it is communicated to the offeree. (See sec. 1382.)

If an acceptance is to be made by mail, it is completed when it is delivered to the offeror's agent (the post office); that is, the acceptance is completed when the offeree's letter, properly

stamped and addressed, is deposited in the mail box. (See sec. 1382).

An offer by mail may be withdrawn so long as it has not ripened into a contract by the offeree's acceptance. An offeree's acceptance by mail creates a contract. Hence the acceptance cannot be withdrawn without the consent of the other party to the contract. (See sec. 1382.)

1382. AI-NY May 1945 (9). (a) Name and explain *five* essential elements of a valid contract, the absence of any one of which would render it void.

(b) (1) If an offer in contract is made by mail, when is the offer completed?

(2) If an acceptance in contract is made by mail, when is the acceptance completed?

(3) May either an offer or an acceptance be withdrawn? When?

(c) A written agreement for the sale of land was drawn by the proposed purchaser and sent to the landowner, who did not sign it but returned it with a letter signed by him, stating, "The inclosed agreement, of this date, is satisfactory. I will sell you the land described in it on the terms which are stated in it." The owner afterwards refuses to sell the land. Is this an enforceable contract? Explain your answer.

(a) See sec. 1380.

(b) (1) The offer is completed when it is communicated. Thus, an offer by mail is completed when it is delivered to the offeree.

(2) Except where an offeror indicates otherwise, an acceptance by mail is completed when it is posted, that is, when it is delivered to the offeror's agent, or agency (the mails) selected to deliver the offer. (See sec. 1381.)

(3) An offer may be withdrawn at any time prior to acceptance, unless the offeror has granted a valid option to the offeree (that is, has made a valid agreement to hold the offer open for a given period). The acceptance, once given, may not be withdrawn without the other party's consent, since it constitutes a contractual obligation binding both parties. (See sec. 1381.)

(c) This is an enforceable contract. The proposal or offer embodied in the written agreement for the sale of land was duly accepted by the owner. The acceptance was evidenced by a signed memorandum (the letter) which incorporated the written agreement into the letter by specific reference to such agreement, the result being the same as if the written agreement had been physically embodied in the letter. A written

memorandum, under the statute of frauds, need not be signed by both parties, but only by the party "sought to be charged," in this case, the owner.

1383. AI May 1938 (5). Discuss the legal effect of offers, counteroffers, and rejections of offers in the formation of a contract. Illustrate by a simple example what is meant by a meeting of the minds.

Three things may happen to an offer: It may be (1) accepted, (2) revoked (withdrawn), or (3) rejected.

(1) If the offer is accepted as made, without qualification, the result is a "meeting of minds," or mutual assent, and the contract is complete if valid in other respects.

(2) The offer may be revoked at any time before it is accepted, either by communicating the revocation to the offeree, or by death or insanity of the offeror; and if acceptance comes after revocation, there is no contract.

(3) An offer may be rejected (a) flatly, by direct refusal, or (b) inferentially, by the making of a counteroffer. If the person making the offer accepts the counteroffer, a contract based on the counteroffer results. If the counteroffer is rejected, the person making it can no longer accept the original offer, because it has been "killed" by the counteroffer, unless, of course, the original offer is renewed. (See secs. 115-117.)

A simple example of what is meant by a meeting of minds is furnished where *A* offers *B* certain merchandise at a given price and *B* says, in effect, "I accept."

1384. AI Nov. 1937 (1). A stationery company wrote to a certified public accountant that "We have quite a few pads of slightly defective but completely usable analysis paper which we now offer you at 45 cents per pad." The accountant wrote in reply: "I accept your offer and I will take one dozen pads." Do these two letters constitute a valid contract?

These letters do not constitute a contract. The first letter was an invitation to trade, rather than an offer (sec. 109). Moreover, it lacks definiteness and certainty (sec. 112).

1385. AI Nov. 1935 (6). Mason and Dana were negotiating and Mason's attorney prepared a long and carefully drawn contract which was given to Dana for examination. Five days later and prior to its execution, Dana's eyes became so infected that it was impossible for him to read. Ten days thereafter and during the continuance of the illness Mason called upon Dana and urged him to sign the contract, but without in any way misrepresenting the contents of it, and Dana signed without reading it. In a subsequent suit by Mason, Dana claimed that the contract was not binding upon him because he had not and could not have read it prior to his signing it. Is Dana's claim a valid defense?

Dana's defense is not valid. Inability to read what one signs because of defective eyesight is no defense where the signature is voluntary, and is not induced by fraud or trickery. (See sec. 111.)

1386. AI Nov. 1938 (5). A stationery supply store voluntarily, and without request by the accountant, delivered by messenger to the accountant's office a package of analysis paper, together with a sealed envelope containing a letter stating that the paper was to be paid for at the price stated or returned within ten days. The package and letter were accepted as a matter of routine by the accountant's reception clerk, who did not know and had no way of knowing their contents. Is the accountant under any legal obligation to answer the letter or to return the package if he makes no use of the analysis paper?

The accountant is under no legal duty to answer the letter or return the package. An offeror cannot compel an offeree to speak or act on penalty of construing silence as acceptance. (See sec. 120.)

1387. AI Nov. 1939 (5). (a) State the various conditions or circumstances which would make a contract fraudulent.

(b) What remedies has the innocent party to a contract which has been procured or induced by fraud?

(a) Fraud is any intentional or reckless misrepresentation of material fact which induces a contract, to one's injury. It may arise in procuring a signature by trickery to a different instrument from the one intended, so that there is no intentional assent (fraud in the *execution*, or *inception*); or it may consist in obtaining intentional assent under circumstances which mar the reality of such assent because of misrepresentations which induced it (fraud in the *inducement*). In the latter event, the misrepresentation may take the form of statements (written or oral), concealment (failure to speak when there is a duty to speak), or deceptive conduct. Fraud may be *actual* (based on misrepresentation of fact) or *constructive* (based on violation of a fiduciary duty).

Regardless of the type of fraud, it is *actionable* if the misrepresentation is one of fact, not opinion; if it is material; if it was made with knowledge of its falsity and with intent to deceive; and if it was actually and rightfully relied on by some person, to his injury.

(b) The defrauded party may (1) rescind and sue at law to recover back the value given; or (2) await suit and interpose the fraud and rescission in defense; or (3) sue in equity

for rescission, and ask for such full equitable relief as the facts may justify; or (4) affirm the contract and sue for damages; or (5) if sued on the contract, counterclaim in damages on the same contract.

(For a full discussion of the nature and elements of fraud, with illustrations, and of the remedies of the defrauded party, see secs. 124-129.)

1388. AI May 1936 (3). What elements or factors must exist in order to constitute a fraud sufficient to vitiate a contract?

(See sec. 1387, subd. (a), 2nd par.)

1389. AI Nov. 1938 (4). An accountant's secretary, in transcribing her notes, erroneously wrote to a prospective client that the per diem charge for a senior accountant was \$25 (instead of \$35, which had been dictated to her) and she signed the accountant's name and mailed the letter. The client immediately wrote to the accountant engaging him "at the rates specified in your letter." The accountant satisfactorily performed the work and now seeks to charge the client \$35 per diem, which is the prevailing rate, of which the client was fully aware at all times. Can the accountant succeed?

If a jury finds that the client, aware that the prevailing rate was \$35, must have suspected that an error was made in quoting the \$25 rate, the accountant should succeed; otherwise not.

Ordinarily a *unilateral* mistake does not furnish the basis for avoidance or rescission, but where one party takes unconscionable advantage of the other party's inadvertent error, and has in no way been misled by the error, nor acted on it, the law will not hold the first party to his error. (See sec. 133.)

The court should instruct the jury that if they find that the client suspected no inadvertence, but merely assumed that the accountant was giving him the benefit of a more favorable rate than the prevailing one, the accountant must abide by his own error, and the jury must find for the client.

1390. NY Oct. 1936 (15). Explain what is meant by the term *duress*. What effect will duress have on the enforcement of a contract?

Duress is coercion causing action or inaction contrary to the victim's will. (See sec. 134.) It renders a contract voidable, at the victim's option.

1391. AI May 1937 (12). State whether a contract between Allen and Benson is valid, voidable, or void in *each* of the following cases, in each case assuming consideration, legality of subject matter, legal capacity to contract, and complete compliance with the statute of frauds:

Allen obtains the contract by threatening Benson that if Benson does not make the contract

(a) Allen will sue Benson for a debt which Allen alleges Benson owes to him;

(b) Allen will have Benson arrested for an alleged defalcation;

(c) Allen will publish defamatory matter concerning Benson's wife.

(a) Valid. The threat of a civil suit does not constitute duress.

(b) Voidable. Threats of criminal prosecution constitute duress regardless of guilt or innocence.

(c) Voidable. A threat to publish defamatory matter concerning a near relative constitutes duress, since its execution might entail pain, distress and injury to victim and relative alike.

(See sec. 134.)

1392. **AI May 1942 (1).** What limitations, if any, are imposed on the power to make legally binding contracts in each of the following classes:

(a) A person who at the time of making what purports to be a contract is drunk.

(b) A person who at such time is obviously of unsound mind.

(c) A corporation.

(d) A person who legally is an infant.

(a) Intoxication is ordinarily no defense to a contract, unless fraudulently procured, or unless it is so extreme as to negative the capacity for intelligent assent.

(b) As to contractual capacity, persons are insane if derangement of mind prevents the giving of intelligent assent. Persons may be *adjudged* or declared insane after inquiry, and a guardian or *committee* appointed to look after their affairs. Prior to such adjudication, contracts with insane persons are *voidable*; thereafter, *void*.

(c) A corporation is an artificial person under the law, and as such may make contracts just as natural persons. However, corporations from their very nature labor under certain disabilities and limitations. A corporation is limited to the objects and powers expressed in its charter or reasonably implied therefrom. (See sec. 877.)

(d) Infants have the right to make contracts, and to hold adults to them, but they are not liable on such contracts except: (1) where the contract involves a necessary to the infant concerned, in which case the infant is liable only for its reasonable value; (2) contracts ratified by the infant; and (3)

business contracts (in some states and under certain conditions).

(See sec. 137.)

1393. AI Nov. 1935 (3). John Barton was nineteen years old and employed as a bookkeeper. He subscribed to a noncancellable correspondence course in accountancy for which he agreed to pay a stipulated amount. He completed half of the course, paid one quarter of the stipulated amount, and thereupon, at the age of twenty, refused to continue the course or to make further payments. What are the rights of the parties?

The Court in a similar case¹ held that a correspondence course is not ordinarily a necessary to an infant, though "circumstances . . . may exist where even such an education might properly be found a necessary." A jury might well find that a correspondence course in accountancy is a necessary to an infant employed as a bookkeeper. If so, Barton would be bound; otherwise not. (See sec. 137.)

1394. AI May 1936 (7). A young man twenty years and eleven months of age who looked twenty-five years of age misrepresented himself to be over the age of twenty-one and made a contract for the purchase of and did purchase an article which was not a "necessary" for which he would be liable. Has the vendor any remedy in a civil (not a criminal) action?

In the *International Text Book* case, cited in the previous section, the Court held that an infant "is not estopped from pleading his infancy by any representation as to his age. . . . To hold otherwise would in many cases deprive infants of the protection extended to them at an age when the mind and judgment are conclusively presumed to be immature and they need to be shielded from their own imprudence and folly." In some states, however, an infant in such cases is liable in a separate action for deceit. See section 137.

1395. AI Nov. 1937 (5). *X*, a minor, made a written contract with *Y*, an adult, whereby *Y* agreed to sell to *X* certain merchandise not constituting necessities. *Y* failed to deliver and *X* sued *Y* for breach of the contract. As a defense, *Y* pleaded the infancy of *X*. Is this a valid defense?

No. The defense of infancy is available only to the infant.

1396. AI Nov. 1940 (9). (a) Define *infant* as the term is used in the law.

(b) In determining whether property or service for which an infant attempted to contract is a "necessary," what factors, circumstances, or considerations are taken into account?

¹ *International Text Book Co. v. Connelly*, 206 N.Y. 188.

(a) An infant is a person of either sex who has not attained the age of "majority" which marks the status of an adult. Such age varies in the different states. At common law and by statute in most states, the age is twenty-one years. (See sec. 24.)

(b) Necessaries embrace food, clothing, shelter, medical attendance, ordinary education and similar fundamentals of living unless they duplicate those already furnished. Beyond these basic requirements, what constitutes a necessary depends on the infant's station in life: his purchasing capacity, his need for the thing in question, and similar factors. See sec. 137.

1397. AI Nov. 1941 (1). (a) Define and illustrate the word "consideration" as used in the law with respect to contracts.

(b) When the consideration for an act is a promise to pay for performance of it, need such performance be of benefit to the promisor?

(a) Consideration is something of value given for a promise. If I promise you \$50 for merchandise to be delivered or service to be rendered, or for the promise to deliver or render the same, such merchandise, service or promise constitutes the consideration for my promise.

(b) The performance of an act, as consideration for a promise, need not be of benefit to the person making the promise, so long as it represents a detriment or sacrifice to the person performing the act. (For an illustration, see sec. 146.)

1398. NY Oct. 1935 (6). Is forbearance to sue a sufficient consideration for a contract? Is the promise to do what a man is obliged to do a sufficient consideration for a contract? Is the payment of a smaller amount before a debt becomes due a good satisfaction?

Forbearance to sue is a sufficient consideration for a contract, provided there is some colorable basis, however doubtful, for the dispute. Forbearance to sue when there is clearly no right to sue, is no forbearance at all.

The promise to do what one is already obliged to do cannot constitute consideration, because it represents no sacrifice on the part of the promisor.

The payment of a smaller amount in discharge of a larger sum not yet due furnishes valuable consideration, because the anticipation of the debt may be mutually agreed upon as the consideration for the difference between the amount paid and the amount actually due.

1399. AI-NY Nov. 1945 (4). (a) Alex agreed with Bowers to relinquish a part of a debt due Alex from Bowers if Bowers would pay the balance. This was reduced to writing and signed by both. Is this a valid contract? Explain.

(b) Aaron writes Bateman offering certain merchandise at \$500. Bateman sends a letter of acceptance by return mail on the day he received Aaron's letter. When does a contract arise? Explain.

(c) Ace contracts for the sale of 5000 tons of steel rails, agreeing to ship 1000 tons per month. He ships 400 tons the first month. Must the buyer go on with this contract? Give your reasons.

(d) A memorandum of sale, naming the buyer and seller, under the statute of frauds, was signed by the buyer but not by the seller. Can the seller hold the buyer liable in an action on the contract of sale?

(a) Ordinarily, payment of a lesser sum than that actually due on a liquidated (undisputed) debt will not constitute consideration for a promise to accept such payment in full satisfaction, that is, such promise will not amount to an enforceable contract (sec. 153). This rule, however, may be modified by statute. Thus, the New York statute provides that an agreement to modify or discharge an obligation shall not be invalid because it lacks consideration, provided the agreement is reduced to writing, signed by the party to be charged (sec. 226, *Release without consideration*).

(b) A contract arises on the mailing of the letter. (See sec. 1381.)

(c) The buyer need not go on with this contract. The contract appears to be entire, not severable (sec. 177). The Uniform Sales Act provides² that "Where there is a contract to sell goods to be delivered by stated installments, which are to be separately paid for, and the seller makes defective deliveries in respect of one or more installments, or the buyer neglects or refuses to take delivery of or pay for one or more installments, it depends in each case on the terms of the contract and the circumstances of the case whether the breach of contract is so material as to justify the injured party in refusing to proceed further and suing for damages for breach of the entire contract, or whether the breach is severable, giving rise to a claim for compensation, but not to a right to treat the whole contract as broken." In a similar case³ the Court said: "Under the cir-

² Sec. 45.

³ *Marrone v. Charles S. Somers Coal Co.*, 195 App. Div. 903, 185 N.Y. Supp. 940. See also, *Smith v. Harrison*, 26 Ga. App. 325, 106 S.E. 191; *Kieckhefer Box Co. v. John Strange Paper Co.*, 180 Wis. 367, 189 N.W. 145. On a failure

cumstances of the case the failure of a defendant to deliver to plaintiff the stipulated amount of coal, seventy-eight tons a week, was of such a nature as warranted plaintiff in refusing to proceed further and in suing for damages for a breach of the entire contract."

(d) The seller can hold the buyer. A written memorandum, under the statute of frauds, need not be signed by both parties. (See sec. 1382, subd. (c).)

1400. NY Oct. 1940 (5). One of the creditors of an insolvent estate withdrew his aid from a suit pending in the interest of all the creditors, upon the defendant's promise to pay his claim in full.

(a) Can he enforce such a contract?

(b) Explain your answer.

(a) The creditor cannot enforce such a contract.

(b) A promise based on the illegal consideration of an unlawful preference is unenforceable.

See sec. 153.

1401. NY Apr. 1941 (7). (a) Can a large contract be bound by a small consideration?

(b) Name four things that will constitute valuable consideration.

(a) A large contract can be bound by a small consideration. Courts are not concerned with the adequacy of consideration, except where the consideration is so grossly inadequate as to suggest fraud.

(b) *Five* things that may constitute consideration are: (1) money; (2) merchandise; (3) services; (4) some sacrifice or detriment, as refraining from exercising a right or privilege; (5) a promise of any of these things.

1402. AI Nov. 1942 (7). A corporation entered into a contract whereby it agreed to plan and supervise the construction and decoration of a restaurant. The state law which was applicable to this contract permitted such work to be done only by licensed architects. The corporation fully performed all of the services required of it by this contract, but the restaurant refused to pay for the services on the true ground that the corporation was not a licensed architect. Is the restaurant's refusal to pay legally justifiable?

The Court held that the restaurant's refusal to pay was legally justifiable (sec. 160).

to deliver an installment the buyer cannot be forced to receive in subsequent installments a greater quantity than that fixed for an installment, in order that the deficiency may be made up. *Lehigh Zinc, etc. Co. v. Trotter*, 42 N.J. Eq. 678, 9 A. 691.

1403. AI Nov. 1939 (11). A solicitor was hired by a corporation to develop its business by procuring new customers, his compensation to consist of commissions. The contract specified that the employment could be terminated by either party on one week's notice and that in the event of termination by either party the solicitor was not to solicit for himself or for any other business organization within the county or within any adjoining county during a period of ten years thereafter.

(a) Is the ten-year provision legally valid?

(b) Would a similar provision be valid if the promise not to solicit was made by the owner of a business as part of a contract whereby the owner sold his entire business (including goodwill) to another person?

(a) The provision would be unenforceable. The law looks with disfavor on contracts which prohibit employees from seeking similar employment elsewhere. An agreement not to engage or accept employment in a competing business is valid, where necessary to protect an employer against disclosure of trade secrets or lists of customers obtained in confidence during the course of employment. In the preceding case, however, the ten-year provision was an unreasonable restraint, wholly unnecessary to protect the employer so long as the employee, upon accepting employment elsewhere, refrained from spiriting away his former employer's customers. The unreasonableness of this restraint is aggravated by the fact that under the contract, the employee might have to pay for a single week of employment by a ten-year denial of similar employment.

(b) The validity of a similar provision, as part of the sale of a business including good will, would depend upon whether the provision was reasonably necessary to protect the good will. The basic test of reasonableness in such cases is whether the restraint is necessary to protect the purchase. (See sec. 161.) If the seller's business extends to the adjoining county, the buyer has a right to extend the restraint to the territory covered. The ten-year period for such restraint does not seem unreasonable and would probably be declared valid.

1404. NY Apr. 1939 (11). (a) State the title of the New York law relative to resale price maintenance.

(b) Describe briefly the principal provisions of this law.

(a) The New York law relative to resale price maintenance is commonly known as the Feld-Crawford Act.⁴

(b) The Feld-Crawford Act provides in effect that it shall not be unlawful to make a contract fixing a minimum sale or

⁴*Unconsolidated Laws* (N.Y.), Retail Price Fixing, sec. 2201.

resale price for a commodity which bears the trade-mark, brand or name of the producer or owner, and which is "in fair and open competition with commodities of the same general class produced by others."

1405. AI May 1935 (1). Plaintiff made a written contract with defendant, a newspaper, whereby plaintiff agreed to become a passenger on an airship from a foreign country to the United States and during said passage to send radio messages to friends in reply to messages sent to plaintiff by said friends. Plaintiff's radio messages were to be reports of the flight which defendant was to publish and for which defendant agreed to pay plaintiff \$5000. Both plaintiff and defendant knew that plaintiff had agreed with the airship company as a condition of his being carried as a passenger that he would send no radio reports of the passage and both plaintiff and defendant knew that a third person had the exclusive news rights. Plaintiff fully performed his part of the contract. Can he compel defendant to pay him the \$5000?

Plaintiff cannot compel defendant to pay the \$5000. An agreement which involves the breach of another contract is void. See secs. 30 and 167.

1406. NY Apr. 1937 (5). The following terms are used to describe contracts: bilateral, entire, executed, executory, express, implied, parol, several, unilateral, written. Arrange these terms in *five* groups and briefly compare the terms in each group and show the differences between them.

- (1) Bilateral and unilateral.
- (2) Entire and several.
- (3) Executory and executed.
- (4) Express and implied.
- (5) Parol and written.

(1) A *bilateral* contract is one consisting of an exchange of promises. A promise given for an act already done, or for an act to be done without promise on the other side to do it, is termed a *unilateral* contract. (See secs. 145 and 174.)

(2) A contract is *entire* when all its parts are so interdependent that they must stand or fall together, so that failure or illegality of one part renders the whole invalid. A contract is *divisible* or *severable* when it is susceptible of division or apportionment, so that failure or illegality of one part does not destroy the whole. The test is usually whether a single consideration or price is fixed for the whole contract (in which case the contract is entire), or whether separate considerations are apportioned to the separate parts (in which case the contract is divisible). (See sec. 177.)

(3) An *executed* contract is one that has already been performed; an *executory* contract, one not yet performed. If one

party has performed and the other not, or if both have partly performed, the contract is partly executory and partly executed.

(4) An *express* contract is one wherein the intent of the parties is shown by words, oral or written.

An *implied* contract is one wherein the intent of the parties is shown by conduct; as where (without mentioning compensation) *A* renders and *B* accepts valuable services.

(5) Strictly speaking, the term *parol*, as applied to contracts, is synonymous with the term *simple*; that is, a *parol* contract is an ordinary informal contract, whether oral or written, as distinguished from a formal contract, such as a contract of record or a contract under seal. However, the word "parol" is sometimes loosely used as synonymous with the word "oral"; as, for example, the "parol evidence rule," which relates to the limitations of *oral* evidence. Therefore, the term, *parol contract* has sometimes loosely and mistakenly been used as synonymous with *oral contract*. This is because the word "parol," used by itself and not in conjunction with contracts, is synonymous with the word "oral."

A written contract is one evidenced by a writing.

1407. AI Nov. 1940 (4). Define the following terms as they relate to the law of contracts so as to differentiate one from another, and give a brief example illustrating each one: (a) void, (b) voidable, (c) unenforceable.

(a) A *void* contract lacks one or more requisites to validity, hence is of no legal effect. *Examples*: (1) *A* says to *B*, "I will sell you my watch for \$35, and *B* replies, "Too much money"; (*No mutual assent*). (2) *B* owes *A* \$500 which is past due, and *A* says to *B*, "I will give you a year in which to pay"; (*no consideration*). (3) *A*, a lunatic, offers to buy *B*'s fountain pen for \$1000; (*no contractual capacity*). (4) *A* agrees to sell and *B* to buy, a large quantity of opium; (*illegal subject matter*).

(b) A *voidable* contract is one wherein one of the parties may, if he wishes, avoid the contract, but which remains valid unless and until it is avoided. *Examples*: A contract based on fraud, or duress, or wherein one of the parties is an infant contracting for a luxury.

(c) An *unenforceable* contract is one which the law will not enforce, either because it is void, or because, though valid, its enforcement is barred for some procedural reason. *Examples*:

(1) an oral contract, valid in all other respects, which should be in writing under the statute of frauds (sec. 182); (2) a valid contract which has become outlawed by the statute of limitations (sec. 96).

1408. AI May 1940 (4). (a) In your state, is the "statute of frauds" a principle of equity or a principle of common law or is it found in one or more statutes enacted by the state legislature?

(b) *X* claims that *Y* fraudulently misrepresented a material fact and thereby fraudulently induced *X* to make a certain contract. Can *X* rely upon the "statute of frauds" in support of his claim?

(a) The statute of frauds is neither a principle of equity nor a principle of common law. It is the name given to a group or collection of statutory provisions relating to agreements that are unenforceable unless evidenced by a memorandum in writing. (See sec. 182.)

(b) No. The statute of frauds has no relation to such transactions. See (a), just mentioned, and sec. 182.

1409. NY Oct. 1939 (4). (a) Explain each of *three* types of contracts required by the statute of frauds to be in writing.

(b) Explain each of *three* types not required thereby to be in writing.

(a) For *thirteen* types of contracts required by the statute of frauds to be in writing, see secs. 183-189 inclusive.

(b) Three types of contracts not required by the statute of frauds to be in writing are:

(1) An agreement for work, labor and services (provided its terms do not require that its performance shall take more than one year from the date of its making).

(2) An agreement for the sale of personal property of the value of less than the statutory minimum (sec. 188).

(3) An agreement for the sale of personal property at a value in excess of the statutory minimum (sec. 188), where there has been either a payment in whole or in part of the purchase price, or a delivery and acceptance in whole or in part of the goods.

Other agreements which need not be in writing are as follows:

(4) An agreement to lease real property for a period of less than one year.

(5) An agreement calling for the sacrifice of some right, provided its performance is not to take longer than one year from the date of its making.

(6) Mutual promises to marry.

1410. NY Apr. 1935 (5). Describe briefly *five* kinds of contracts that must be proved by some memorandum in writing.

For a description of thirteen such contracts, see secs. 183-189.

1411. NY Apr. 1942 (15). To be enforceable, must these agreements be in writing? Give the reason for your answer in each case.

- (a) *X* agrees to buy goods to the amount of \$100.
- (b) *X* pays \$10 and agrees to buy \$100 worth of goods.
- (c) *X* takes goods of the value of \$100 without payment.
- (d) *X* guarantees the payment by *B* for \$100 worth of goods.
- (e) *X* agrees to buy goods to the amount of \$20 for delivery in fifteen months.
- (f) *X* pays \$100 and agrees to complete the purchase of land in thirty days.

(a) Yes. An agreement to buy or sell goods of the value of \$50 or over (this being a New York question) must be evidenced by a writing.

(b) No. An agreement to buy or sell goods of the value of \$50 or over, accompanied by a down payment, need not be evidenced by a writing.

(c) No. An agreement to buy or sell goods of the value of \$50 or over need not be evidenced by a writing if it is accompanied by delivery and acceptance of the goods, or any part of them.

(d) Yes. A special promise to answer for the debt of another must be evidenced by a writing. (See sec. 185.)

(e) Yes. An agreement which by its terms is not to be performed within one year from the date of its making must be evidenced by a writing.

(f) Yes. An agreement for the sale of an interest in lands must be evidenced by a writing. Payment on account, in a contract for lands, does not satisfy the statute.

1412. AI Nov. 1936 (12). In 1930, John Adams orally promised his brother Henry that he would advance to Henry all cash needed by Henry to enable the latter to take a university course in accountancy, obtain a certificate as a C.P.A. and equip an office for the public practice of accountancy. Henry orally agreed to repay these advances out of the first fees collected by him in his practice as a C.P.A. John made these advances, amounting in total to \$6000, and Henry completed the course, became a C.P.A. in 1935, and began to practise as such. After collection of his first fees, Henry refused to repay any part of the advances, relying upon the statute of frauds.

- (a) Upon what provision in the statute of frauds did Henry rely?
- (b) Does the statute of frauds bar a recovery by John?

(a) Henry relied on the provision that an agreement which is not to be performed within one year from the date of its making must be evidenced by a writing or it will not be enforced.

(b) The statute of frauds will not bar a recovery by John. To prevent unjust enrichment, the law will imply a contract whereby Henry will be required to repay the loan. (See sec. 194). Obligations of this character are known as *quasi contracts* (sec. 172).

1413. NY Oct. 1935 (7). Under what conditions must a contract to sell be in writing? State the exceptions.

The following contracts to sell must be in writing:

(1) Contract for the sale of any interest in real property.

(2) Contract for the sale of any interest in personal property, including a *chose in action*, if the thing sold be of the value of \$50 or over (in New York; other amounts, in other states). Exceptions:

(a) Where, at the time of the contract, the buyer receives and accepts the whole or any part of the goods sold.

(b) Where, at the time of the contract, the buyer pays the whole or any part of the purchase price.

(c) Where, if the sale is by auction, the auctioneer at the time of the sale enters a memorandum in his sale book specifying the nature and price of the goods sold, the terms of sale, the name of the purchaser, and the name of the person on whose account the goods were sold.

1414. AI May 1938 (1). In transactions covered by the statute of frauds, other than sales at public auction, what should the note or memorandum specify and by whom and how should it be signed?

The note or memorandum should (a) sufficiently identify the subject matter of the contract, (b) name or identify the parties, (c) state the consideration, (d) embody the terms of the contract, and (e) contain the signature of the party to be charged or his duly authorized agent.

1415. AI May 1935 (8). At a conference in the office of the Simpson Corporation, a duly authorized representative of the Tompkins Corporation arranged orally with a duly authorized representative of the Simpson Corporation for the Tompkins Corporation to sell to the Simpson Corporation merchandise of the value of \$1000. The representatives then prepared a memorandum of this sale on a Simpson form used by that corporation in selling merchandise to its customers, because the Tompkins representative had with him no order blanks of his own. At the top of the

form the Simpson Corporation's name and address were printed. The name of the Tompkins Corporation was written on a blank line following the words "Sold to," and that corporation's address was written following the word "Address." These items and a description of the merchandise sold and the terms of the sale were written on the form by the Tompkins representative. Did the name of the Tompkins Corporation thus written constitute its signature under the statute of frauds?

The facts described in the above problem are identical with the facts in the case of *Lucky Strike Coat Co., Inc. v. Julius Forstmann Corporation*,⁵ wherein the sole question presented was whether there was a signature of the party to be charged in compliance with the statute of frauds. The Court held that there was no such signature. To quote from the opinion: "Is the name of the seller, thus written in the space provided for the name of the purchaser, following the printed 'Sold To,' to be considered the seller's signature? There is no reason to assume from an examination of the memorandum itself that the seller's name was there inserted in this manner for the purpose of serving as its signature; such an assumption is necessarily based on speculation. It is an essential requirement of the statute of frauds that there be found a signature which unequivocally establishes the intent of the party sought to be charged therewith to adopt the memorandum by setting his hand thereto. 'A signature, however, there must be, and a name, written or printed, is not to be reckoned as a signature unless inserted or adopted with an intent, actual or apparent, to authenticate the writing. The defendant must have intended not merely to contract, but to sign.' *Mesibov, Glinert & Levy, Inc., v. Cohen Brothers Manufacturing Co., Inc.*, 245 N.Y. 305, at page 310 and pages 311, 312, 157 N.E. 148, 149. The purpose of the statute would be defeated if the court were to admit extrinsic evidence in order to determine whether the defendant intended to sign, when no man can tell from an inspection of the paper itself.

"In the case⁶ at bar, the memorandum is insufficient to charge defendant as seller, first, because nothing appears thereon which may be taken to be the signature of the seller, made by it with intent to be bound by the instrument, and second, because nothing therein identifies the defendant as seller; to the contrary, the defendant is named as purchaser and parol evi-

⁵ 152 Misc. 21, 272 N.Y. Supp. 688.

dence establishing that it is the seller would be in direct contradiction of the writing."

1416. AI Nov. 1941 (2). In August, 1941, X and Y duly made a legally valid written contract whereby X agreed to audit the books and accounts of Y for the calendar year 1942 for a fee fixed by this contract. At the time of the making of this contract and as a part of the negotiations leading up to it, X and Y orally agreed that said contract was to be effective only in the event that Y procured certain additional capital from Z prior to January 1, 1942. If Y is unable to procure such capital, is the written contract legally binding?

No. This is one of the exceptions to the *parol evidence rule*, which provides that once parties have reduced an oral agreement to writing, they must abide by the writing and must not attempt to vary or contradict it by oral evidence. The exception, in this case, is that oral proof of a condition precedent (obtaining the necessary capital) is permissible. Such oral proof does not merely vary or contradict the writing: it goes much further. It shows that the writing failed as a contract because of the failure of a condition on which the contract depended. See sec. 195, subd. (2).

1417. NY Apr. 1940 (4). As a bookkeeper or auditor you are examining a contract prepared upon a printed form with some typewriting and some pen writing thereon, and you conclude that the document has been carelessly drawn because:

There are conflicts between figures and words.

There are conflicts between printing, typewriting and manuscript.

There are portions of the contract which are ambiguous, and constructions which could be placed upon some portions of it would make the contract absurd or illegal in those respects.

(a) What would be your opinion as to the consideration to be given to (1) the absurd construction, (2) the illegal construction, (3) the ambiguous statement, (4) technical or trade words, (5) conflicts between figures and words, (6) conflicts between print and writing, (7) conflicts between pen writing and typewriting.

(b) Having given seven short answers to the above, state briefly the principle of construction upon which your opinions are based.

(a) (1) The absurd construction will be rejected.

(2) The illegal construction will be rejected.

(3) The ambiguous statement will be construed against the party who drew the contract.

(4) Technical or trade words will be given their technical or trade meaning.

(5) The words will prevail.

(6) The writing will prevail.

(7) The typewriting will prevail.

(b) Following are the principles of construction supporting the above conclusions:

(1) Words will not be construed in their ordinary, grammatical sense, if to do so would be to give the words an absurd meaning. (See sec. 196, subd. (b) for an illustration.)

(2) Where one construction will make a contract legal and the other not, the parties will be presumed to have intended a legal contract. (For an illustration, see sec. 196, subd. (e), and sec. 158.)

(3) Ambiguous words will be construed against the party who drew the contract and selected the words. (For an illustration, see sec. 196, subd. (f).)

(4) Technical and trade words are given their technical and trade meaning. ("Lights" of glass, for example, in a contract with a glazier, would mean *panes* of glass. "Prime" used in conjunction with ribs of beef would have a different meaning when used to describe a coat of paint.)

(5) Where words and figures conflict, the words prevail.

(6) Conflicts between print and writing are resolved in favor of writing.

(7) Conflicts between pen writing and typewriting are resolved in favor of pen writing.

1418. AI Nov. 1942 (8). *X* executed a written contract with *Y* whereby *X* agreed to purchase from *Y* all of the raw silk which *X* needed in his business. The contract contained no termination date and no provision for terminating the contract. For how long a period of time will this contract remain in force and how can it be terminated, other than by mutual agreement?

The arrangement is terminable at will, for two reasons:

(1) *Y* made no commitment to sell; hence the contract lacks mutuality and is binding on neither party (sec. 147).

(2) If we assume a commitment by *Y* to sell, the contract must be construed as one at will. A contract containing no provision for termination is terminable at will. (See sec. 196, subd. (i).)

1419. AI and NY Nov. 1944 (3). (a) Allen loaned money to Bass on Bass's promise to pay to Carlton a like amount which Allen owes to Carlton.

(1) Can Carlton recover from Bass?

(2) What principle of law is involved? Explain.

(b) Austin entered the employ of Bell under an agreement to remain for one year at the annual salary of \$3600 payable semimonthly. After working for seven months, Austin was offered employment by Curtis at the rate of \$5000 a year. Austin informed Bell and notified him of his intention to quit at once unless Bell paid him the said rate. Bell said, "I am in need of your services and cannot afford to let you go. If you will remain with me, I will pay you the additional compensation at the end of your term." Austin said he would remain. At the end of the year, when Austin's term expired, Bell discharged Austin and also refused to pay him the additional compensation as he had agreed.

What are Austin's rights under the Law of Contracts?

(c) Name and explain at least *five* simple contracts that must be in writing to be enforceable under the statute of frauds.

(a) (1) Carlton can recover from Bass.

(2) The "third party beneficiary rule" (sec. 200), known in some states as the doctrine of Lawrence against Fox, applies to this situation. Where one person makes a promise to another for the benefit of a third, the latter may hold the promisor, provided the promisee is obligated to the third party.

(b) Austin has no rights. When he agreed to remain the rest of the year, he gave nothing for Bell's promise to pay the difference, because he merely promised to do what he was already obligated to do. (Sec. 153.) A promise given for no consideration is unenforceable.

(c) For *thirteen* such contracts, see secs. 183-189 inclusive.

1420. AI Nov. 1941 (8). At a time when *X* owed *Y* \$100, *Z* sought to borrow \$100 from *X*. *X* lent \$100 to *Z* upon *Z*'s oral promise to *X* to pay to *Y* in one month the \$100 which *X* owed to *Y*. When *Z* failed to pay, *Y* sued *Z* but *Z* claimed that the statute of frauds prevented recovery by *Y*.

(a) Upon what provision in this statute did *Z* rely and was it a valid defense for him?

(b) Do the facts stated suggest any other defense which might be available to *Z*?

(a) *Z* relied on the provision of the statute of frauds that a special promise to one person to answer for the debt, default or miscarriage of another must be in writing to be enforceable. Such provision was not a valid defense to *Z*. *Z*'s promise to *X* was not a promise by a guarantor or surety to a creditor to *answer for* the obligation of a debtor (that is, it was not a promise to pay only in case the debtor failed to pay). Such a promise would have had to be in writing to be enforceable (sec. 185). Instead, we have here a promise by *Z*, not made to the creditor (*Y*), but to the debtor (*X*), to *pay* the creditor (*Y*). Such a promise need not be in writing.

(b) *Z* might urge the defense that he made no promise to *Y*, but to *X*, and that *Y* was not a party to the contract between *X* and *Z*. Ordinarily, such a defense would be valid. In this case, however, we have a promise made for the benefit of a third party (*Y*), to a promisee (*X*), who is indebted to such third party. This brings the case within the Third Party Beneficiary Rule (sec. 200) and renders *Z*'s defense invalid.

1421. NY Oct. 1936 (1). State five ways in which a contract once entered into may be discharged.

Five ways in which a contract once entered into may be discharged are:

(1) By *performance*. This is the natural way for a contract to be discharged.

(2) By *agreement*. Parties may always agree, upon sufficient consideration, to discharge one another from further liability under an existing contract.

(3) By *impossibility* of performance, where the contract was based on an implied condition that certain factors would continue to exist throughout the life of the contract, and where such factors, by ceasing to exist, render performance impossible. (For example, a personal service contract is based on the implied condition that the person to perform will continue to live and will be in sufficient health to discharge the contract. In such case, death or sickness might excuse performance and discharge the contract.) Note: not all contracts are discharged merely by the fact that they subsequently become impossible of performance. (See, in this connection, sec. 231.)

(4) By *operation of law*. A change in the law which was in effect at the time the contract was made, may discharge a contract; or the law itself may provide for a discharge in certain cases. For example, a contract to build a garage on a given site would be discharged by a zoning ordinance forbidding the erection of a garage within a given zone embracing that site; or, a contract obligation may be extinguished by a discharge in bankruptcy.

(5) By *breach*. If one of the parties to a contract fails or refuses to perform some condition upon which performance by the other party depends, the latter is discharged by the former's breach.

1422. AI Nov. 1943 (2). (a) In what five ways may a contract be discharged?

(b) What is a tender and what is its effect?

(c) A entered the employment of B under a contract whereby B agreed to give A, in addition to the wages of \$40 per week, a "fair share of the profits of the business," to be determined on the first day of January. Does this agreement give a right of action against B for more than \$40 per week?

(a) See preceding section.

(b) A tender is an offer to do what one is required to do. It enables the tendering party, in case of breach, to show that he was ready to do his part, and it places the other party more clearly in default.

(c) No. An agreement to pay a "fair share" of the profits is void for indefiniteness and has been so declared by the courts. What constitutes a "fair" share is not susceptible of definite ascertainment; it furnishes no specific concept on which minds can meet.

1423. AI Nov. 1936 (3). A soap-manufacturing company gave a coupon with each cake of soap and advertised in every practicable way that it would give an adult's round-trip ticket to a specified amusement park for every twenty-five coupons presented. Plaintiff, a stamp and premium broker, duly presented 100,000 coupons and demanded 4000 tickets. The manufacturing company refused to deliver the tickets.

(a) Can plaintiff compel delivery of the tickets?

(b) If not, what remedy, if any, has plaintiff?

(a) The plaintiff cannot compel delivery of the tickets. The equitable remedy of specific performance is not available where the remedy at law (damages) is adequate.

(b) Plaintiff's remedy is to sue at law for damages, and the Court so held in this case.⁶ The Court pointed out that at the time the premium coupons were issued, they contained no provision against assignment. The plaintiff therefore had a right to acquire the coupons by assignment. As to damages, said the Court, "I think the proper rule to apply in this case is the highest market value of the Crystal Beach tickets at the time the plaintiff was entitled to receive the same, which was 25 cents each." The court therefore awarded \$1000 damages: 100,000 coupons = 4000 tickets = \$1000.

1424. AI Nov. 1935 (1). The Printing Company contracted with the Cook Company to supply stationery to the latter during a stated period, on a cost-plus basis. The contract defined cost as "actual cost of labor and material (including an amount of administrative and overhead charges, attributable to the performance of said agreement, satisfactory to the Cook

⁶ *Payne v. Lautz Bros. & Co.*, 166 N.Y. Supp. 844, aff'd 168 N.Y. Supp. 369, aff'd 185 App. Div. 904, 171 N.Y. Supp. 1094.

Company, which said sum is to be determined by the Cook Company after an audit and examination by the Cook Company of the books and accounts of the Printing Company)." The Cook Company, after its audit, notified the Printing Company that the overhead charges made by the latter were not satisfactory to the Cook Company. The dissatisfaction was actual and not capricious but was based on points in dispute among outstanding accountants. Is the Printing Company conclusively bound by the Cook Company's position?

The Printing Company is bound. When one party agrees that performance of a contract shall be satisfactory to the other party, the latter may reject performance as unsatisfactory, regardless of what the ordinary reasonable person might have done under like circumstances. Such rejection for dissatisfaction must be in a matter involving judgment, where opinion, taste or fancy might reasonably differ; otherwise, the alleged dissatisfaction would not be real, but spurious and capricious. In this case, the matter in dispute is one on which outstanding accountants differ. The dissatisfaction is actual, not capricious. Whether it is *reasonable* is immaterial. (See sec. 218.)

1425. NY Oct. 1938 (2). Define (a) substantial performance, (b) good tender, (c) good consideration, (d) condition concurrent.

(a) Substantial performance is performance that is essentially, though not technically, complete.

Under the old common law, a party who undertook the performance of a given task, for a stipulated payment, had to perform that task in full to the letter, or he could recover nothing. The rigor of this rule has since been relaxed, to prevent undue hardship. If, for example, a party undertakes to construct a building, and substantially completes it, minor omissions or defects will not bar a recovery. The value of such defects and omissions may be set off by the owner against the payment claimed by the builder.

(b) Tender is an offer to do what one is required to do. When the offer is complete and unqualified, and squares exactly with one's obligation (as, for example, an offer to do exactly what one is required to do under a contract), such offer is called a *good tender*. The offer is not a good tender if it is in any way qualified; for example, an offer to pay a debt on the condition that the creditor give a receipt. (See sec. 222.)

(c) Good consideration, as distinguished from valuable consideration, is consideration based on natural love and affection,

sentiment, or moral obligation (as distinguished from legal obligation). For example, a promise to one's wife or son, based on natural love and affection, is a promise based on good consideration. A promise to pay a debt outlawed by the statute of limitations is a promise based on a moral, rather than on a legal obligation, hence based on good, not valuable consideration. (See sec. 149.)

(d) Conditions concurrent are those which are mutually dependent and are to be performed at the same time. *Examples:* (1) Simultaneous contributions of capital investment between prospective partners as conditions for the creation of the firm; (2) Simultaneous delivery and payment as conditions for a sale. (See sec. 217.)

1426. NY Apr. 1935 (15). What is a debt? When a partial payment is made on a debt that bears interest, in what manner is the payment applied? Is a debtor legally entitled to a receipt?

A debt is a sum of money due upon contract, express or implied.

When partial payment is made on a debt that bears interest, "the rule is to apply the payments in the first place to the discharge of the interest then due. If the payment exceeds the interest then due, the surplus goes toward discharging the principal, and interest is to be computed thereafter on the balance of the principal. If the payment is less than the interest, the surplus of interest must not be taken to augment the principal, but interest continues on the former principal until the payments, taken together, exceed the interest due; and then the surplus is to be applied toward discharging the principal, and interest is to be computed on the balance of the principal as before."⁷

A debtor is not legally entitled to a receipt. Although there are exceptions in a number of jurisdictions, the general rule is that a debtor cannot insist upon a receipt in full in respect to the particular claim upon which the tender is made, or a receipt in full for all demands, and if he does so he forfeits the tender; nor can the offer be made conditional upon the debtor receiving a discharge. A tender is held to be vitiated by coupling it with a demand for a receipt for the sum offered, unless, as in the case in some jurisdictions, a statute exists which allows a demand for a receipt. The rule in New York as expressed in *Roosevelt*

⁷ 33 *Corpus Juris* 250.

v. Bull's Head Bank,⁸ reflects the prevailing attitude of the courts: "The tender when made was accompanied by a satisfaction piece which the plaintiff was requested to sign. This he was not bound to do. The money should be tendered irrespective of any other act. If a receipt or satisfaction piece is asked for, it vitiates the tender."

1427. NY Oct. 1938 (13). What is the law with regard to the application of payments on an account?

"A debtor paying money to a creditor to whom he owes several debts may direct the application of the payment because the money is his and he may do as he will with it and control its application. But the debtor must exercise his option as to the application when he makes the payment. After that the money has ceased to be his and is no longer subject to his control. Then it belongs to the creditor, and he is master of it, and may control its application."⁹

Therefore, when a debtor owes several debts to the same creditor and makes a payment on account, he should specify to which account he wants the payment applied. Otherwise, the creditor may apply it to whichever account he prefers; and if one of the accounts bears no interest and the others do, he may, in the absence of direction from the debtor, apply the payment to the noninterest-bearing account.

When payments are made on open account and neither debtor nor creditor designates or applies the payment to any given item, the law will presume that it is to be applied to the earliest item of the account.

1428. NY Apr. 1943 (13). To assist a nephew who was starting in business for himself, an uncle loaned him \$1500 on January 1, 1933, and thereafter made other advances as follows: January 1, 1934, \$1000; January 1, 1936, \$1500; January 1, 1938, \$1000; January 1, 1939, \$500 and January 1, 1940, \$1000; total \$6500.

The nephew repaid \$1500 on January 1, 1941, stating in the letter of transmittal that it was for the advance made to him on January 1, 1936; on January 1, 1942, he repaid \$1000 and on January 1, 1943, \$1500; total \$4000, leaving the balance not repaid \$2500.

⁸ 35 Barb. (N.Y.) 579-583. To the same effect: *Commercial F. Ins. Co. v. Allen*, 80 Ala. 571, 1 So. 202; *Jacoway v. Hall*, 67 Ark. 340, 55 S.W. 12; *Butler v. Hinckley*, 17 Colo. 523, 30 P. 250; *Thayer v. Brackett*, 12 Mass. 450; *Parker v. Supreme Tent, Knights of Maccabees of the World*, 191 Mo.App. 508, 177 S.W. 722; *Baird v. Union Mut. Life Ins. Co.*, 104 Neb. 352, 177 N.W. 156; *Siter v. Robinson*, 18 S.C.L. 274; *Sanford v. Bulkley*, 30 Conn. 344; *Kitchen v. Clark*, 1 Mo.App. 430; *Holton v. Brown*, 18 Vt. 224.

⁹ *Bank of California v. Webb. et al.*, 94 N.Y. 467, 472.

- (a) What is the situation between the parties as to this balance?
- (b) What topics of commercial law are involved?

(a) As of April 29, 1943, the nephew still owed \$2500 on which the uncle could enforce collection.

(b) The topics of commercial law involved are the statute of limitations and the application of payments to different accounts. (See section 221, "Performance by payment.")

When a debtor pays money to a creditor to whom he owes several debts, he may, at the time of payment (but not after, when the money is no longer his) direct the application of such payment to a particular account. If he does not do so, the creditor may apply it as he prefers. The nephew applied the first payment of \$1500 to the January 1, 1936 loan. This left the following unpaid loans (as of January 1 in each case):

1933	\$1500
1934	1000
1938	1000
1939	500
1940	1000

The nephew's subsequent payments aggregating \$2500 were unaccompanied by direction as to how they were to be applied. The uncle could therefore apply them, if he wished, to the outlawed 1933 and 1934 loans, leaving the 1938, 1939 and 1940 loans aggregating \$2500, still due and unpaid.

The uncle could, of course, apply the subsequent payments to the later loans which were not outlawed. If he did, this would leave, unpaid and unenforceable, the outlawed 1933 and 1934 loans.

1429. NY Oct. 1940 (6). Smith owes Jones four debts as follows:

- \$100 which is barred by limitation
- 200 which is past due but not barred
- 300 which is currently due
- 400 which has not yet become due

(a) Smith pays Jones \$300, without designating how it is to be applied. How may Jones apply it?

(b) Smith pays Jones \$300, stating that it is for the debt currently due. Does Smith's designation of the debt to be discharged control?

(c) Discuss and compare your answers.

(a) Jones may apply the payment to any of the debts except the one not yet due.¹⁰

¹⁰ *Farwell v. Importers etc. Nat. Bank*, 90 N.Y. 483.

(b) Yes.

(c) See secs. 221, 1427 and 1428.

1430. AI May 1944 (2). (a) In a case where a debtor owes several debts to the same creditor and makes payment of one of the debts what is the rule to be followed by the creditor for the application of the payment?

(b) What is the rule where interest accrued on the several debts?

(c) After appropriation is made, can it be changed? How?

(d) *A*, an accountant, sent *B* a bill for \$1000 for personal services. There had been no agreement as to the price to be paid. *B* on receiving the bill, sent a letter to *A* questioning the reasonableness of the amount charged but did not dispute the service, enclosing a check for \$500 which he stated was in full satisfaction of *A*'s claim. *A* made no reply and deposited the check in the bank. He subsequently sued *B* to recover the \$500 as balance due. Is he entitled to recover?

(a) See secs. 221 and 1427-1429.

(b) See sec. 221, "Application of payments: principal and interest."

(c) After appropriation is made, it cannot be changed, except (1) with the consent of the debtor, (2) for fraud of the debtor, or (3) where the wrong account has clearly been credited in error.

(d) *A* is not entitled to recover. Cashing the check constituted an accord and satisfaction. (See sec. 227.)

1431. AI May 1939 (1). *X*, a dealer, makes numerous sales to *Y*, and at the end of each calendar month *X* sends *Y* an itemized statement. Some but not all of the charges by *X* bear interest. Because of unsettled disputes, a few of the items listed on the statement of April 30, 1939, had been billed for over five years. *Y* is about to make a payment on account. Has *Y* the right to compel *X* to apply this payment to items of principal or interest specified by *Y*, at the time of payment? Or has *X* the right to apply this payment as *X* desires, (a) if *Y* specifies the application, (b) if *Y* does not specify? If *X* has a right to apply the payment as *X* desires, within what time should he exercise it, and what notice if any should *X* give *Y* concerning the application made by *X*?

Y has the right to compel *X* to apply the payment to items of principal or interest specified by *Y* at the time of payment. The money is his, and he can say what he wants done with it.

(a) If *Y* specifies the application of his payment, *X* has no right to apply the payment as *X* desires.

(b) If *Y* does not specify the application of his payment, *X* may apply it as he sees fit.

X has a reasonable time in which to apply the payment, but he must make an election before controversy and suit. (See sec. 221, "Application of payments to different accounts.")

1432. AI Nov. 1936 (6). An investment company sold certain bonds to Clark but refused to take Clark's cheque in payment although Clark offered the cheque in time to enable the vendor to have it certified before delivery of the bonds. Clark refused to give a cheque already certified, but by agreement between the parties the vendor delivered the bonds to a bank in which the vendee had a balance sufficient to cover the purchase price and accepted that bank's cashier's check and the bank immediately delivered the bonds to the vendee. Thereafter, but before the cashier's cheque could be cashed, the bank failed. Can the vendor recover the purchase price from the vendee?

The vendor cannot recover the purchase price from the vendee. When a creditor accepts a cashier's check as payment and the bank fails, the creditor has no further claim against the debtor. (See sec. 221, "Cashier's check.")

1433. NY Oct. 1936 (12). When a valid debt exists for a certain sum of money, does a receipt for a lesser sum, specifying that it is "in full of the debt" or "of all demands," bar the creditor from collecting the amount unpaid? Explain.

When a valid debt exists for a certain sum of money, the debt is said to be "liquidated." When a debt is liquidated, it cannot be discharged, except upon payment in full. A receipt for a lesser sum, reciting that it is "in full of the debt," or "of all demands," merely recites a falsehood, for the payment of a lesser sum than that actually due on a *liquidated* debt, cannot be "in full of the debt," since it lacks full consideration.

Neither can an agreement to accept a smaller sum as payment in full of a larger debt be deemed an accord and satisfaction. In order that an agreement to accept a smaller sum than that claimed shall constitute an accord and satisfaction, the claim must be *unliquidated*—that is, one for an amount not previously agreed upon, or definitely fixed by some commitment in the form of a contract, draft or note. Only when an honest dispute on an unfixed or *unliquidated* amount exists, will the acceptance of a smaller sum, for a larger one claimed, constitute an accord and satisfaction.

In *Nordlinger v. Libow*,¹¹ plaintiff received a check by mail for 35% of his claim. The check bore the following legend: "The retention and acceptance of this check is in full settlement of any and all claims, etc." It appears that the claim was a liquidated one. In a subsequent suit by plaintiff, defendant set up the retention and cashing by plaintiff of the

¹¹ 136 Misc. 438, 240 N.Y. Supp. 193.

check with the aforesaid legend as a full accord and satisfaction. Said the court: Regarding the transaction as an accord and satisfaction between the defendants and the plaintiff, regardless of the other creditors, the legend on the check is unavailing. It is elementary that to establish an accord and satisfaction by the payment of a lesser amount than that claimed to be due there must be a bona fide dispute as to the amount. This essential fact does not appear in any of the papers. Failing this, the check must be regarded as a payment on account and the writing upon its reverse a mere nullity."

In New York (this being a New York question), the statute provides that a signed, written agreement to change, modify or *discharge* an obligation is binding regardless of consideration; but we are dealing here, not with an agreement, or even a release, but with a receipt, which is to be distinguished from a release. (See sec. 226, "Release and receipt distinguished.")

1434. AI Nov. 1939 (8). *X* and *Y* were having a genuine controversy as to the amount of indebtedness due by *X* to *Y* when *X* mailed to *Y* *X*'s check for an amount less than that claimed by *Y*. On the face of this check *X* had written "This check is in full settlement of my indebtedness to *Y*," and with the check *X* enclosed a letter written by him to *Y* in which he stated that the enclosed check was in full settlement. *Y* did not acknowledge receipt, or otherwise communicate with *X*, or do anything whatever with this check except to retain it in his office for two months.

(a) Can *X* successfully claim that his indebtedness had been settled in full?

(b) What is the legal name of the agreement, or method, of settlement attempted by *X*?

(a) The rule is not uniform whether, under these circumstances, failure to return a check within a reasonable time constitutes an accord and satisfaction. In New York, it does; in Illinois, it does not. The New York rule reflects the majority view. (See sec. 227, "Mere retention of a debtor's check.")

(b) The method of settlement attempted by *X* is that of accord and satisfaction.

1435. AI May 1938 (3). Plaintiff, the owner and in possession of certain merchandise, requested defendant to procure a purchaser, but made no agreement with defendant as to compensation. Defendant procured a purchaser, collected the sales price specified by plaintiff, and sent to plaintiff a check for the proceeds less 10% commission. Plaintiff cashed the check but protested at once that the deduction was unauthorized and now sues to recover it. Was plaintiff's acceptance of this check an accord and satisfaction?

Plaintiff's acceptance of the check was not an accord and satisfaction. An accord presupposes a prior dispute. In the absence of a genuine dispute, there can be no accord and satisfaction. (See sec. 227, "Undisputed claims; no genuine dispute.")

1436. NY Oct. 1943 (7). (a) Define the term *account stated*.

(b) During a period of several years *X* and *Y* have sold merchandise and made payments to each other but they have not agreed as to the status of their accounts. Each furnishes to the other an itemized statement of his account, and the statement of each contains items not shown in the statement of the other. *X*'s statement shows *Y* owes him \$1540. *Y*'s statement shows that *X* owes him \$220. *Y* writes to *X* that he admits he owes a balance of \$250; and *X* writes to *Y* that he will agree to this balance, although neither party has furnished a fully revised statement. Discuss the effect of these statements and letters as constituting an account stated.

(a) "An account stated is an agreement between parties who have had previous transactions of a monetary character that all the items of the account representing such transactions, and the balance struck, are correct, together with a promise, express or implied, for the payment of such balance."¹² (See sec. 228.)

(b) The statements and letters constitute an accord and satisfaction rather than an account stated, since they involve a disputed or controverted claim, rather than a mere agreement upon the accuracy and correctness of a creditor's statement. (For further distinction between account stated and accord and satisfaction, see sec. 228.)

1437. NY Oct. 1941 (8). (a) Define *account stated*.

(b) Define *accord and satisfaction*.

(c) Compare or contrast the two terms in *a* and *b*.

(a) See section 1436.

(b) An accord is an agreement between parties to a dispute, to accept a new arrangement in place of the disputed one. A satisfaction is the carrying out of an accord.

(c) An accord signifies a compromise. An account stated represents acquiescence or admission rather than compromise. It simplifies proof by reason of such admission and prevents subsequent challenge of the facts thus admitted. (See sec. 228.)

1438. AI May 1937 (1). Answer the following questions on the law of contracts:

¹² 1 *Corpus Juris Secundum* 693.

- (a) State what is meant by anticipatory breach and give an example.
- (b) State what is meant by novation and give an example.
- (c) What is the effect on a contract of a mutual mistake of fact?
- (d) What is the effect on a contract of a mutual mistake of law?

(a) An anticipatory breach is the renunciation of a contract in advance of its performance date, as where *A* agrees on June 1st to deliver a carload of grain on September 1st and announces on July 1st that he will not deliver. (See sec. 237.)

(b) Novation is the substitution of a new contract, or a new debtor or obligor, for an existing one; as where I contract to build you a house of certain material, and thereafter, because of scarcity in that material, we cancel the old contract and substitute a new one calling for the construction of a different type of house; or where, owing to my inability to perform, you agree to let me out as the builder and to accept a substitute in my place.

(c) A mutual mistake of fact signifies no true meeting of the minds. Its effect is to prevent the formation of a binding contract, so that either party may, because of it, avoid or rescind the contract.

(d) A mutual mistake of law has no effect on a contract. (See Example (2) of sec. 132.)

1439. NY Oct. 1935 (1). Define and explain each of the following terms or expressions relative to contracts: (a) special damages, (b) liquidated damages, (c) legal tender, (d) substantial performance.

(a) "Special damages are those which are the actual, but not the necessary, result of the injury complained of, and which in fact follow it as a natural and proximate consequence in the particular case, that is, by reason of special circumstances or conditions. Hence general damages are such as might accrue to any person similarly injured, while special damages are such as did in fact accrue to the particular individual by reason of the particular circumstances of the case."¹³

Example: You agree to manufacture for me 1000 dresses in given styles and sizes, at \$1.00 a dress. The market value of such dresses, manufactured, is \$1.25 a dress. However, I have a special customer who is willing to pay \$1.50 a dress. In case of your breach, my general damages would be the difference between the contract price and the market price, or \$250. But if, when we made our contract, you knew of my special customer who was willing to pay \$1.50 a dress, and if, in my complaint, I plead my special damages and the facts giving rise thereto, I may recover not only gen-

¹³ *Black's L. Dic.*, p. 314.

eral damages of \$250, but additional special damages of \$250 because of the special circumstances affecting my case.

(b) "Liquidated damages constitute the compensation which the parties have agreed must be paid in satisfaction of the loss or injury which will follow from a breach of contract. They must bear reasonable proportion to the actual loss. *Seidlitz v. Auerbach*, 230 N.Y. 167, 129 N.E. 461. Otherwise an agreement to pay a fixed sum, upon a breach of contract, is an agreement to pay a penalty, though the parties have chosen to call it 'liquidated damages', and is unenforceable."¹⁴

(c) Legal tender is money a creditor must accept in payment of a debt. (See sec. 222.)

(d) Substantial performance is performance that is essentially, though not technically complete. Recovery is allowed for substantial performance under the following conditions: (1) *bona fide* effort toward full compliance; (2) no wilful or intentional departure from contract; and (3) no major defects, deviations or omissions. (See sec. 220.)

1440. **AI Nov. 1935 (4).** In June, 1929, Herman was an internal-revenue agent entitled to certain pension and retirement rights. On July 1, 1929, at the instigation of the X Corporation, he resigned and entered the employ of the X Corporation under a written contract which provided that during the rest of his life he was to devote his entire time to the corporation as assistant to the president, for which he was to be paid a salary of \$5120 per annum. On November 13, 1929, the X Corporation discharged him without cause. Assuming that no question of *ultra vires* was involved, what are his rights under the contract?

Assuming that no question of *ultra vires* is involved (sec. 887), Herman has a cause of action against the X Corporation for breach of contract. This being a personal service contract, no action in equity for specific performance will lie (sec. 243). Upon breach of an employment contract, a continuing or periodic tender of readiness to perform throughout the remainder of the contract term is unnecessary; neither is it necessary to bring periodic suits for salary installments as they become due. Instead, the employee may consider the full lifetime period in basing his damage for the breach, and may bring a single suit to recover full damages immediately upon his discharge. The Court may charge a jury that in fixing damages, they may consider the following:

1. *Broad rule:* The broad rule of damage in such cases is that

¹⁴ *Wirth & Hamid Fair Booking v. Wirth*, 265 N.Y. 214, 223.

the employee may recover such sums as would and should have been paid had the contract not been breached, from the last earning period before the discharge up to the date of trial, plus the present money value of all future salary payments that would have been due under the contract, less what the employee has earned or should have earned in the interim, and less what he might reasonably be expected to earn during the remainder of the contract term.

2. *Life expectancy.* In fixing the probable aggregate of salary installments for the rest of the employee's life, regard should be had to the employee's age, health and other factors entering into a computation of life and salary expectancy.

3. *Present value of future increments.* The present value of future increments is less than the sum of all such increments, because money in hand is worth more than money in the future. Thus, if Herman's probable life expectancy is twenty-five years, the present value of his future salary installments is substantially less than twenty-five times \$5120.

4. *Mitigation of damage.* The employee, like any other party whose contract has suffered an anticipatory breach (sec. 237), is required to mitigate the damage (sec. 240) by seeking other employment, although there are cases which hold that he need merely seek similar employment in the same vicinity. However, under the majority of decisions, the employee is not required to go forward with proof that he could *not* find substitute employment unless the employer submits proof that he *could*.

5. *Loss of pension and retirement rights under prior position.* The jury, in fixing damages, would have no right to consider the pension and retirement rights which Herman gave up under his previous position as an internal-revenue agent, because these would be included in the salary fixed under the lifetime contract, in consideration of which Herman gave up such benefits.

In *Brighton v. Lake Shore & M.S. Ry. Co.*,¹⁵ the Court sustained a jury charge which included the following instructions in connection with the breach of a lifetime contract: ". . . In estimating the present value of such contract, or, in other words, the damages to the plaintiff by reason of the breach of such contract, you should consider his age, his health, his abil-

¹⁵ 103 Mich. 420, 61 N.W. 550.

ity to labor, and the probable duration of his life. . . . He has no right to remain idle. It is his duty to labor as best he may, and his measure of damages must in part be controlled by his ability to work and earn wages and otherwise decrease his apparent damages. . . . You should also consider the fact that, in allowing the plaintiff damages for breach of this contract, he will now, at the present time, be receiving moneys which otherwise he would only obtain in the future as the same were earned, and that hence the present value of such services of the plaintiff, if not allowed and paid, must be materially less than their aggregate sum."

1441. AI Nov. 1938 (10). (1) Define specific performance.

(2) In what circumstances, if any, can a buyer of personal property legally demand specific performance of the contract by the seller?

(1) Specific performance is the actual performance of a contract, which may be decreed by a court of equity where the remedy of damages for nonperformance would be inadequate.

(2) A buyer of personal property can legally demand specific performance by the seller only when such property is unique and not readily obtainable on the open market. When a seller breaches his contract to deliver 100 crates of eggs at \$4.80 a crate, and eggs on the market are \$6.00 a crate, there is no reason why the buyer needs the aid of a court of equity: He can buy the eggs on the open market and sue at law for the difference as his damages. But when the personal property bought is unique and not readily obtainable on the market (such as antiques, heirlooms, famous paintings, manuscripts and first editions of books, ancient coins and relics, patents, copyrights, or shares of stock in a closely held corporation), the remedy at law would be inadequate, and specific performance would lie.

1442. AI Nov. 1940 (12). *X* owns 48% of the capital stock of a corporation conducting a profitable but highly competitive business, *Y* holds 49%, and *Z* holds 3%. *X* enters into a legally binding contract with *Z* for the purchase of *Z*'s stock. *Z*, without excuse, breaches his contract and refuses to deliver the stock. What can *X* legally do about it?

X can sue for specific performance of the contract to deliver the stock, because the remedy at law in such case would be inadequate. (See sec. 1441.)

1443. AI May 1941 (7). *X*, an auditor, had established an extensive and valuable reputation for his skill in uncovering defalcations in stock-

brokerage firms. He made a legally binding contract to work as employee for a firm of certified public accountants, but without excuse he refused to abide by his contract.

(a) Can the firm obtain an injunction compelling *X* to carry out his contract? What is the legal name of this type of injunction?

(b) Can the firm obtain an injunction forbidding *X* to enter the employ of any other firm of certified public accountants?

(c) If an injunction of either type were obtained and *X* violated it, by whom and how would he be penalized?

(a) The firm cannot obtain an injunction compelling *X* to carry out his contract. Such injunction, were it available, would be known as a *mandatory* injunction (sec. 243). Mandatory injunctions are rarely issued, and never in a case requiring a person to render personal services. In exceptional cases, however, where a person has contracted to render unique and extraordinary services but refuses to carry out his agreement, a court may grant a decree having the effect of a prohibitory injunction, declaring in effect that so long as the defendant refuses to fulfill his contract, he will be restrained from rendering similar services to anyone else. (See sec. 243.)

(b) The firm would in all probability not obtain an injunction forbidding *X* to enter the employ of another firm. The law looks with disfavor on contracts which prohibit employees from seeking similar employment after terminating their contracts (sec. 165). The likelihood of obtaining such an injunction is still less where, as here, the employee has not even begun to work, and the employer is in no position to urge that business secrets may be divulged to a competitor unless an injunction is issued. We do not even have, in this situation, a contract wherein the employee covenants, upon termination of his services, not to engage in similar employment. In dealing with employment contracts, the courts have granted prohibitory injunctions only in the rarest cases, where the services are extremely unique and extraordinary (involving exceptional artistic or other unique talent), or where the services are tied up to business secrets, lists of customers, and so on.

(c) If an injunction were to issue in a case of this sort, it would be a *prohibitory*, as distinguished from a *mandatory* injunction (sec. 243). The penalty would be either a fine, or imprisonment, or both, imposed by a court of equity for violation of its injunction.

- 1444. NY Apr. 1940 (6).** (a) Define arbitration and state its purpose.
 (b) What controversies may not be submitted to arbitration?
 (c) Contrast an arbitration with a reference by a court.

(a) Arbitration is a procedure for settling disputes out of court. The object is to save parties the expense of litigation, and the public the expense of a trial.

(b) Matters involving the following may not be decided by arbitration:

(1) A controversy affecting an ownership interest in real property; that is, an interest amounting to a fee or life estate (sec. 1027).

(2) Claims arising out of illegal contracts or transactions.

(3) Criminal liability.

(c) An arbitration may be contrasted with a reference by a court in three respects: (1) as to source of authority, (2) as to finality of decision, and (3) as to procedure. (See sec. 246.)

- 1445. AI May 1943 (6).** (a) Define arbitration.

(b) How is an arbitration provided for?

(c) How are arbitrators appointed?

(d) What is the outcome of an arbitration and is it enforceable?

(a) See sec. 1444.

(b) Arbitration may be provided for either by (1) an *agreement to arbitrate* a controversy which *may arise thereafter*, as by a provision in a contract to settle any dispute thereunder by arbitration; or by (2) a *submission*, by which parties agree to submit an *existing* controversy to arbitration.

(c) The agreement or submission may provide for an arbitrator agreeable to both sides, or it may provide that each is to select an arbitrator, the two to select a third, or umpire. In the latter event, the designation must be in writing.

(d) The outcome of an arbitration is an *award*, which, when duly confirmed by the Court, may be enforced by entering judgment thereon.

(For details on the above items, see secs. 244, 248, 253 and 256.)

- 1446. NY Apr. 1938 (6).** (a) Define and explain arbitration.

(b) If a provision to arbitrate disputes is found in a contract (executed under the New York law), will the provision for arbitration be valid, irrevocable and enforceable?

(c) What will be the effect if the arbitrators are not named in the contract? Explain.

(a) See secs. 244 and 1444.

(b) In New York, the statute provides that arbitration agreements and submissions "shall be valid, enforceable and irrevocable, save upon such grounds as exist at law and in equity for the revocation of any contract" (such as fraud, duress, and so on).

(c) In case of failure to select an arbitrator or umpire, or to provide a method for selecting one, or to fill a vacancy, the Court will designate one on application of either party.

1447. NY Apr. 1942 (1). (a) Is an arbitration clause in a contract relating to interstate commerce enforceable? Give the reason for your answer.

(b) May a partner bind his copartners by submission of a partnership matter to arbitration? Give the reason for your answer.

(c) May a certified public accountant act as arbitrator? Explain.

(a) An arbitration clause in a contract relating to interstate commerce is enforceable not only in the Federal courts (sec. 245, Footnote 96) but also under state arbitration statutes, since jurisdiction is voluntarily bestowed by parties who agree to arbitrate. For example, patent suits can be tried only in a Federal court, but a dispute over a patent infringement may be arbitrated under a state arbitration statute.¹⁶ Similarly, though Congress has legislative jurisdiction over interstate commerce, disputes arising out of interstate commerce may be submitted to state or Federal arbitration.

(b) A partner may not bind his copartners by submission of a partnership matter to arbitration. The Uniform Partnership Act requires unanimous consent of partners to such a submission. (See sec. 684.)

(c) Yes. (For comment on attorneys and accountants acting as arbitrators, see sec. 253 and footnote.)

1448. NY Apr. 1944 (6). A house-building contractor, who claims that wooden doors for the house delivered to him by a manufacturer of interior trim were not made from seasoned lumber as specified and will not pass the architect's inspection and receive his approval, asks your advice as to a lawsuit or an arbitration. You advise the latter.

(a) Can your client require the manufacturer to submit to arbitration?

(b) If an arbitration is to be commenced, state, with reasons for your advice, whether you would suggest to your client that he select as one arbitrator a housebuilder, a door manufacturer, the architect or some other person.

¹⁶ *Covicchi v. Mohawk, etc.*, 34 F. Supp. 852.

(c) If the award does not suit your client, state, with reasons for your advice, whether you would suggest to your client that he ask counsel to take the matter to court.

(a) No. Arbitration is a voluntary proceeding, resting on mutual assent. There is no such thing as compulsory arbitration, except where the parties have already agreed to arbitrate.

(b) The architect should not be designated as an arbitrator, since his position has been indicated in advance ("will not pass the architect's inspection"). This might render him vulnerable on a motion to vacate the award for partiality. However, there is no reason why the housebuilder or door manufacturer should not be eligible; indeed, their knowledge of the business might be of great value in reaching a just result. "Knowledge of a business, and the methods used therein, may be of great value in reaching a just result because of the ability of an arbitrator to apply such knowledge to the facts. To hold that because of such knowledge one is disqualified to act as an arbitrator would bring about a very unjust result. There may be occasions when it is necessary to secure arbitrators with knowledge of the particular business out of which the transaction has arisen and which is the subject of the arbitration. Such arbitrators may be much better equipped than those who know nothing about the subject matter of the arbitration."¹⁷

(c) The award, if valid, is binding, and recourse to the law courts would be unavailing. Only where the award is improper (see sec. 255) will the courts interfere.

1449. AI May 1943 (5). During a period of two months, X made twenty separate sales of textiles to Y. On the invoice for each sale, X stamped the following in red ink: "All controversies arising from the sale of these goods are to be settled by arbitration." Y retained all invoices, using voucher checks for payments which he made. Y at no time made any mention, either oral or written, of the matter stamped on the invoices. Can X compel Y to submit to arbitration a controversy concerning one of these sales?

The facts of this problem are identical with those in the case of *Tannenbaum Textile Co. v. Schlanger*.¹⁸ The Court of Appeals, reversing orders of the courts below, ruled that a party cannot be held to an arbitration agreement without his consent and that silence operates as an assent only when it has the effect to mislead.

¹⁷ *Newburger v. Rose*, 228 App. Div. 526.

¹⁸ 287 N.Y. 400.

CHAPTER III-A

Negotiable Instruments

1450. AI Nov. 1941 (4). (a) What is meant by the law merchant?

(b) In what circumstances is a negotiable instrument payable to bearer?

(c) *X* and *Y* signed a legally valid promissory note wherein they promised to pay \$200 at a specified bank to the order of *Z* on September 1, 1941. *Y* signed this note for the accommodation of *X*, which fact was known to *Z*, and *X* promised *Y* that *X* personally would pay the note. The note was not paid at maturity. Can *Z* hold *Y* without formal presentation and notice of dishonor?

(d) If the drawee of a negotiable bill of exchange refuses to write his acceptance on the face of the bill, what are the holder's rights?

(a) The law merchant is a body of law based on precedent and made up of decisions in disputes among merchants and mariners that were originally pronounced by mercantile courts and later adopted as the law of the land. It embraces that branch of law known as "bills and notes," or negotiable instruments, also insurance and similar branches of mercantile law. (See sec. 258.)

(b) A negotiable instrument is payable to bearer in any one of the following situations:

(1) When it so provides.

(2) When it is payable to a person or bearer.

(3) When it is payable to cash.

(4) When it is intentionally made payable to a fictitious or nonexistent person or to a bookkeeping account such as "Pay-roll," "Petty Cash," "Sundries," and so on.

(5) When the payee's name does not purport to be the name of any person.

(6) When the only or last indorsement is in blank (sec. 299).

(c) Yes. An accommodation maker, though known to be such to the holder, is, as to the latter, primarily liable; hence he remains liable notwithstanding nonpresentment. (See sec. 346.)

(d) The holder may treat the bill as dishonored (sec. 340) and hold the drawer and indorsers.

1451. NY Apr. 1942 (13). (a) Which of the following are essential in a negotiable note?

(b) Which if any, must be handwritten?

(For brevity you may reference your answers, as (1)a, (2)a, (1)b, (2)b, and so on.)

- | | |
|------------------------|--------------------------|
| (1) For value received | (8) Payee |
| (2) Place where made | (9) Amount in words |
| (3) Date when made | (10) Amount in figures |
| (4) Date when due | (11) Interest in words |
| (5) Promise to pay | (12) Interest in figures |
| (6) Payee or order | (13) Place where payable |
| (7) Payee or bearer | (14) Maker's signature |

(a) (4), (5), (6), (7), (9) and (14).

(b) None

(See secs. 262-272.)

1452. NY Apr. 1939 (2). (a) What are the essential elements of a negotiable instrument?

(b) State which of the following instruments are negotiable:

(1) April 18, 1939—One year from date, I promise to pay C. Jones one hundred dollars. (Signed) F. Smith.

(2) On or before April 18, 1939, I promise to pay to the order of C. Jones ten ounces of gold. (Signed) F. Smith.

(3) Thirty days from date I promise to pay to the order of C. Jones 100 bushels of wheat or one hundred dollars at his election. (Signed) F. Smith. Dated March 19, 1939.

(a) An instrument, to be negotiable:

“(1) Must be in writing and signed by the maker or drawer;

“(2) Must contain an unconditional promise or order to pay a sum certain in money;

“(3) Must be payable on demand or at a fixed or determinable future time;

“(4) Must be payable to order or to bearer; and

“(5) Where the instrument is addressed to a drawee, he must be named or otherwise indicated therein with reasonable certainty.”

(b) (1) Not negotiable. The instrument is not payable to order or to bearer.

(2) Not negotiable. The instrument is not payable in money.

(3) Negotiable. The Uniform Negotiable Instruments Act¹ provides: “An instrument which contains an order or

¹Sec. 5.

promise to do any act in addition to the payment of money is not negotiable. But the negotiable character of an instrument otherwise negotiable is not affected by a provision which * * * gives the *holder* an election to require something to be done in lieu of payment of money."

1453. **AI May 1942 (9).** Does the inclusion, by the maker, of the following clause in a promissory note payable in installments make it non-negotiable: "In the event of my failure to pay any of such installments at the time above specified therefor, all of the remaining principal and interest shall, at the option of the holder hereof, be immediately due and payable, without notice"?

No. Negotiability requires that the sum payable be certain, and a sum is certain though payable in installments, coupled with a provision that on default the whole becomes due. (See sec. 266.)

1454. **AI Nov. 1940 (3).** State in each of the following cases whether the negotiability of an otherwise negotiable instrument would be destroyed if:

- (a) It were written in pencil.
- (b) It contained the following promise: "I promise to deliver to John Smith or order 100 tons of gold-bearing ore from the North Star mine."
- (c) It contained the following promise: "I promise to pay James Jones or order \$1000 when he becomes 21 years of age."
- (d) It contained the following promise: "I promise to pay Richard Rose \$100" at a specified date.

(a) Negotiability would not be destroyed (sec. 263).

(b) Negotiability would be destroyed. The instrument would not be payable in money.

(c) Negotiability would be destroyed, for lack of a certain maturity (sec. 274).

(d) Negotiability would be destroyed. The instrument would not be payable to order or bearer.

1455. **AI May 1937 (4).** An instrument in the following form was written by Denby on a Saturday and on the following day delivered by him to Morrison:

On demand I promise to pay to the order of William Morrison
One Thousand Dollars (\$1000) with interest at 6%.

This was not signed but at the time it was written Denby, in Morrison's presence, stamped it with a rubber stamp stating Denby's name in the form ordinarily used by Denby.

- (a) Is this a negotiable instrument?
- (b) Is it enforceable by Morrison against Denby?
- (c) When does it become overdue?

(a) The instrument is negotiable. The stamped signature is sufficient (sec. 263).

(b) The enforceability of the instrument would depend upon the Sunday statutes of the particular state. In states that have statutes declaring Sunday business transactions void, instruments given on Sunday in connection with such transactions are likewise void, provided the fact of Sunday issuance is apparent on the face of the instrument. But if an instrument, though given on Sunday, is dated as of a week day, the person so dating it is estopped, as to a holder in due course, from setting up as a defense the fact that it was actually issued on a Sunday.

(c) Demand instruments become overdue upon the lapse of a reasonable time after their issue, except that a demand bill does not become overdue until the lapse of a reasonable time after its last negotiation. The Negotiable Instruments Act provides that in determining what is a "reasonable time" or an "unreasonable time," regard is to be had to the nature of the instrument, the usage of trade or business (if any) with respect to such instruments, and the facts of the particular case. Court decisions throughout the country have varied widely as to reasonable and unreasonable periods. For examples, see sec. 347.

1456. NY Apr. 1936 (13). What must a negotiable instrument not contain? Mention three exceptions to this rule.

A negotiable instrument must not contain an order or promise to do any act in addition to the payment of money.

Four exceptions to this rule are:

(1) A provision that authorizes the sale of collateral securities in case the instrument be not paid at maturity.

(2) A provision that authorizes a confession of judgment if the instrument be not paid at maturity.

(3) A provision that waives the benefit of any law intended for the advantage or protection of the obligor, such as waiver of protest, and so on (see sec. 370).

(4) A provision that gives the holder an election to require something to be done in lieu of payment of money.

1457. AI Nov. 1938 (7). A promissory note, properly dated and signed, read as follows: "One year from date, for value received, I promise to pay to the order of the Mercantile Bank the sum of two hundred sixteen dollars

(\$216), there having been deposited herewith as collateral security pass book No. 15043 issued by your compound-interest department in my name, and I agree to deposit in said compound-interest account the sum of eighteen dollars (\$18) on the fifteenth day of every month hereafter until a total of the face amount of this note shall have been deposited." Is this note negotiable?

The note is not negotiable. Reference to the deposit of the pass book as collateral does not affect the negotiability of the instrument. But the provision for monthly deposits constitutes a promise to do an act in addition to the payment of money. Such act is not a provision for payment by installments, transferable with the instrument. As to a remote holder, the note would be payable in one year; as to the immediate parties, monthly deposits are required. This violates the rule that a negotiable instrument must travel freely on its own (sec. 260) as "a courier without luggage, whose countenance is its passport" (sec. 309).

1458. AI May 1943 (11). A dealer in raw sugar made a sale to a refiner who accepted a draft for the goods and delivered it to the vendor. The draft was in the usual commercial form except that the direction to charge the account of the vendor was followed by the words: "On account of 14,789 bags Cuban centrifugal sugar as per contract 4/25/39." Does the addition of these words render the draft nonnegotiable?

The addition of the words in question does not affect the negotiability of the draft. The order to pay was unconditional. The direction to charge the vendor's account in no way qualified the unconditional character of the order. (See sec. 273, subd. (g).)

1459. AI Nov. 1939 (2). A depositor in a bank learned that the bank had dishonored several small checks drawn by him on the ground of "insufficient funds," although the depositor's balance had been sufficient to cover them. Upon investigation, he found that the bank had charged his account with \$80 paid by it on another check drawn by him that stated the amount in figures as \$80, but in writing as "Eight and no/100 Dollars," and that he had regarded and intended as a check for \$8. The insufficiency of funds according to the bank's accounts had resulted from this transaction. What principles of law are involved in determining whether the depositor has any legally enforceable claim against the bank for damages?

The following principles of law are involved:

(1) Where the sum payable in an instrument is expressed in words and also in figures and there is a discrepancy between the two, the sum denoted by the words is the sum payable (sec. 277, subd. (a)). Hence the bank should have charged the depositor's account with \$8 instead of \$80.

(2) A bank occupies the relationship of debtor to the depositor as its creditor in the full amount of the account. The bank is under a duty to the depositor, but not to the holder (sec. 376), to honor the depositor's checks in the correct amount thereof, against sufficient funds on deposit. A failure to discharge this duty, whether deliberate or through mistake, renders the bank liable to the depositor.

(3) The damages recoverable by the depositor would depend on the loss that he could prove he sustained because of the bank's dishonor of the several small checks drawn by the depositor. Unless real loss could be shown, nominal damages only (sec. 239) would be recoverable. (See, in this connection, sec. 1493.)

1460. NY Oct. 1939 (5). (a) Name *three* common types of negotiable instruments.

(b) What are the *five* legal requirements of a contract constituting a valid negotiable instrument?

(c) What constitutes a material alteration of a negotiable instrument and what is the result of such an alteration?

(a) Broadly, negotiable instruments fall into two classes: *promissory notes* and *bills of exchange*. Promissory notes take various forms, such as (1) ordinary notes by private individuals or business concerns, (2) bank notes, (3) certificates of deposit, (4) due bills, (5) judgment notes, and (6) bonds. Variations of bills of exchange include (7) drafts, (8) checks, (9) bank drafts, (10) letters of credit, (11) traveller's checks, (12) trade acceptances, and (13) money orders.

(b) See sec. 1452.

(c) Any alteration that changes:

(1) The date;

(2) The sum payable, either for principal or interest;

(3) The time or place of payment;

(4) The number or the relation of the parties;

(5) The medium or currency in which payment is to be made; or that adds a place of payment where no place of payment is specified, or any other change or addition that alters the effect of the instrument in any respect, is a material alteration.

"Where a negotiable instrument is materially altered without the assent of all parties liable thereon, it is avoided, except as against a party who has himself made, authorized or assented to the alteration, and subsequent indorsers. But when

an instrument has been materially altered and is in the hands of a holder in due course, not a party to the alteration, he may enforce payment thereof according to its original tenor.”²

1461. AI-NY Nov. 1945 (12). An accountant, in making a cash audit of the John Jones Company, finds in the cash drawer the three papers described below. Give your opinion as to the classification, the negotiability, and the valuation of each.

(1) “First National Bank

New York, N.Y.—May 1, 1944

This is to certify that John Doe has deposited with this bank one thousand dollars (\$1000) payable six months from date, with interest at four per cent per annum upon return of this certificate properly endorsed
B—Cashier”

(2)

“May 1, 1944

Due John Jones Company one thousand dollars

T. A. Smith”

(3) A note payable to John Jones Company from a customer in England payable in New York in English pounds, shillings, and pence.

(1) This has been held by the court to constitute a negotiable certificate of deposit. Its valuation would be \$1000 plus interest at 4% from November 1, 1944.

(2) This is a due bill. It constitutes a demand note, payable forthwith without actual demand. Since it is due forthwith, and specifies no rate of interest, it bears interest at the legal rate (sec. 1060) from its due date, namely, from the date of the due bill (sec. 1062), except, as stated, that no actual demand is required in this case. Hence, its valuation is \$1000 plus interest at 6% from May 1, 1944. The instrument is not negotiable, since it is not payable to order or to bearer.

(3) This is a valid promissory note. It is not, however, negotiable, because it is not payable to order or to bearer. The fact that it is payable in New York in English pounds does not in itself deprive the instrument of negotiability; “That cannot apply to notes made abroad, which incidentally come before our courts.”³ The valuation of this note would be its equivalent in dollars and cents at the current rate of exchange.

1462. NY Apr. 1937 (2). (a) Designate the parties whose names or other identifications must be shown in a note, a draft and an acceptance.

(b) Describe the relationship of *each* of these parties to the instrument.

(c) Write an ordinary form of acceptance.

² Uniform Negotiable Instruments Act, sec. 124.

³ *Hebblethwaite v. Flint*, 185 App. Div. 249, 173 N.Y. Supp. 81, 85.

(a) *Note*: Maker and payee.

Draft: Drawer, drawee (acceptor), payee.

Acceptance: Same as in draft, except that drawer and payee are the same.

(b) *Note*: The *maker* of a note is the person who “makes” it, that is, who signs and agrees to pay it. The *payee* is the person to whom, or to whose order, the instrument is payable.

Draft: The *drawer* is the person who draws the instrument upon another and requests the latter to pay it. The *drawee* is the person upon whom the instrument is drawn, that is, the person who is requested to pay the instrument. If the drawee accepts the instrument, that is, engages to pay it when due, he becomes the *acceptor*. The *payee* is the person to whom, or to whose order, the draft is payable.

Acceptance: Same as in draft, except that drawer draws upon the drawee in favor of himself as payee.

(c) For an ordinary form of acceptance, see Question 31 on page 198.

1463. NY Apr. 1935 (3). When is a person deemed to be an indorser? What warranties are implied to all subsequent holders in due course by one who indorses without qualification?

“A person placing his signature upon an instrument otherwise than as maker, drawer or acceptor is deemed to be an indorser, unless he clearly indicates by appropriate words his intention to be bound in some other capacity.”⁴

Every indorser who indorses without qualification, warrants to all subsequent holders in due course:

(1) *That the instrument is genuine and in all respects what it purports to be* (for example, that the instrument is not forged or that a person signing it as an agent is duly authorized).

(2) *That he has a good title to it* and that all prior transferors had good title.

(3) *That all prior parties had capacity to contract* (which would prevent the indorser from setting up as a defense, against a subsequent holder in due course, that the maker of a note was an infant, lunatic or idiot).

(4) *That the instrument was valid and subsisting at the time he indorsed it.* (If, for example, a note is issued by a partnership or corporation for the accommodation of a third

⁴ Uniform Negotiable Instruments Act, sec. 63.

party, the indorser may not urge such fact in defense of his liability, because he has warranted the instrument to be valid and subsisting at the time of his indorsement.)

In addition to the above warranties, the Uniform Negotiable Instruments Act⁵ goes on to provide with respect to one who indorses without qualification:

"And, in addition, he engages that on due presentment, it (that is, the instrument) shall be accepted or paid, or both, as the case may be, according to its tenor, and that if it be dishonored, and the necessary proceedings on dishonor be duly taken, he will pay the amount thereof to the holder, or to any subsequent indorser who may be compelled to pay it."

1464. NY Apr. 1938 (5). Name *four* kinds of indorsements that may be found on notes, checks, drafts, and so on. Give an example of each.

Six kinds of indorsements that may be found on notes, checks, drafts, and so on, are:

(1) *Indorsement in blank* ("general" indorsement): Specifies no indorsee and consists merely of the indorser's signature. *Example:* A mere signature, "Walter Watson," on the back of an instrument.

(2) *Special (or "full") indorsement:* Makes instrument payable to the order of a named person. *Example:* "Pay to the order of Sarah Jane Moore. Walter Watson."

(3) *Restrictive indorsement:* One that (1) prohibits negotiation, or (2) makes the indorsee the indorser's agent, or (3) vests title in the indorsee in trust for or to the use of another. *Examples:* "Pay to Sarah Jane Moore only," or "Pay to the Transcontinental Trust Company for collection," or "For deposit only."

(4) *Qualified indorsement:* Qualifies the indorser's function and liability by limiting them to the mere act of passing title to the instrument. *Example:* "Without recourse. Walter Watson." (Note: Such qualification does not, however, relieve the indorser from liability on certain warranties. See sec. 322).

(5) *Conditional indorsement:* Renders the indorser liable only upon a specified condition or conditions. *Examples:* "Pay to Dixie Cotton Company against my receipt for 32

⁵Sec. 66.

standard bales cotton, Snow White brand," or "Pay to King Coffee Growers Ass'n upon delivery of warehouse receipt for 12 sacks of Blended Ambrosia Coffee."

(6) *Irregular or anomalous indorsement*: Made by a third party (other than the payee or the holder), who affixes his name to an instrument, with or without additional words, for a purpose other than to transfer title to it, the usual purpose being to lend credit to the instrument by way of accommodation.

1465. AI Nov. 1937 (3). On October 14, 1937, X steals two legally valid negotiable notes payable to bearer (one due October 21, 1937, and one due November 22, 1937) and corporate bearer bonds with the November 1, 1937, coupons attached. On October 22, 1937, X sells both notes and the bonds to Y, who pays full value and has no knowledge, either actual or constructive, of the theft by X.

(a) Can Y collect from the maker on either or both of these notes?

(b) Can Y collect from the corporation on the November 1, 1937, coupons?

(a) Y can collect from the maker on the note due November 22, 1937, but not on the note due October 21, 1937. Both notes, being payable to bearer, were negotiable by delivery. As to the former, since Y acquired it before maturity, he was a holder in due course (sec. 308) and valid delivery of the note, as to him, must be conclusively presumed (sec. 292). As to the second note, however, since Y acquired it after its maturity (sec. 308, subd. (2)), he was not a holder in due course. Not being a holder in due course, he could not acquire any better right to the instrument than that of his transferor, the thief. His only recourse is against the thief.

(b) Y can collect from the corporation on the November 1, 1937 coupons. Bearer bonds are negotiable by delivery. Y acquired, before their maturity, the coupons attached to the bonds and due November 1, 1937. He therefore became, as to them, as to all subsequent coupons, and as to the bonds themselves, a holder in due course. Hence, as to him, valid delivery of the bonds, including the coupons, must be conclusively presumed. (See sec. 280, "Bond".)

1466. NY Oct. 1936 (7). State the essentials of a holder in due course. Briefly describe his rights.

A holder in due course is one who has taken a negotiable instrument under the following conditions:

(1) That it is complete and regular on its face.

(2) That he became the holder of the instrument before it was overdue and without notice that it had been previously dishonored if such was the fact.

(3) That he took the instrument in good faith and for value.

(4) That at the time the instrument was negotiated to the holder, he had no notice of any infirmity in the instrument or defect in the title of the person negotiating it.

(See sec. 308.)

1467. NY Oct. 1943 (12). (a) Can the purchaser of a negotiable instrument acquire rights under it greater than the vendor had? Give reasons.

(b) Criticize the following note as to its negotiability, covering all points:

September 19, 1943

Sixty days after date (if not before that date) for value heretofore received by me, I promise to pay to John Doe..... or bearer One hundred dollars \$100.00 in wheat at \$1.00 per bushel, with interest @ 6%

William Roe

(a) As a holder in due course, the purchaser of a negotiable instrument may acquire rights greater than the vendor had. A holder in due course may enforce collection of the instrument against prior parties regardless of their claims, defenses and offsets against one another (except for *real* or *absolute* defenses, such as forgery, and so on, explained in sec. 334). The maker, for example, may have given the note to the payee without getting anything for it, or he may have a claim or offset against the payee equal to or greater than the amount of the note itself, or one of the indorsers may have a claim against his indorsee. All these claims, counterclaims and offsets of prior parties against one another are of no concern to a holder in due course. Though the vendor of the instrument may be subject to them, the holder in due course is not. This is because it is the very essence of negotiability that one who acquires a negotiable instrument in due course shall be free from those claims, offsets and counterclaims that do not appear on the surface of the instrument and that would otherwise impede its free negotiability.

(b) The note is nonnegotiable on several grounds:

(1) Since the words "if not before that date" create the reasonable inference that the maker reserves the right to pay the instrument at some date prior to sixty days after date, at his

option, the instrument is not payable at a fixed or determinable future time and is therefore not negotiable.

(2) The words "for value heretofore received by me" and the provision for interest do not affect the negotiability of the note one way or the other (sec. 272).

(3) The promise to pay John Doe, standing alone, would have deprived the note of "words of negotiability" (sec. 269), but the added words "or bearer" supply the omission. A note payable to a named person or bearer is negotiable (assuming that all the other requisites are present).

(4) The promise to pay in wheat violates the requisite that a negotiable instrument must be payable in money. The note would therefore be nonnegotiable on this ground alone, even if it lacked none of the other requisites.

1468. AI Nov. 1943 (4). (a) The payee of a negotiable note for \$1000 negotiates it to his creditor as collateral security for a debt of \$700. How much may the indorsee recover?

(b) *M* executes his negotiable note, payable to the order of *P*, and delivers the same to *P* for value. *P* indorses the note "without recourse," and negotiates it to *A* for value. The instrument is dishonored at maturity on presentment to *M*. *A* sues *P*. Is he liable?

(a) Assuming that the maker has no defenses to the instrument, the indorsee may recover the full \$1000, but he must account to the payee for the excess over the amount of the debt, that is, for \$300. If the maker has a *real* or *absolute* defense (sec. 334), the indorsee will recover nothing, because such a defense is good as against the world, including a holder in due course. If the maker has a personal defense only (sec. 333), such defense will not avail against the indorsee up to the amount of the debt secured (\$700), because to that extent the indorsee is a holder for value in due course; but as to the excess (\$300), the indorsee's position is no better than the payee's; that is, the maker's personal defense would avail, and the indorsee's recovery would be limited to \$700. Where a note is taken as collateral security for a debt, the transferee is a holder for value in due course to the extent of the debt for which it is pledged, but only to that extent.⁶

(b) *P* is not liable. A qualified indorser (sec. 302) does not undertake to be liable if the instrument is not paid at maturity (sec. 322).

⁶ 10 *Corpus Juris Secundum* 808-809.

1469. NY Oct. 1942 (15). Brown receives from Jones and Smith two notes that are identical in amount, maturity and all other respects, except that Jones has indorsed the one generally, whereas Smith has indorsed the other without recourse.

Compare or contrast Brown's rights against the respective indorsers:

- (a) If either or both notes are found to be forgeries.
- (b) If either or both notes were made or indorsed by parties incapacitated therefor.
- (c) If either or both indorsers did not have good title.
- (d) If, though the notes were invalid for any reason, the indorsers had no knowledge of that fact.
- (e) If either or both makers become insolvent.

(a), (b) and (c). Both Jones and Smith are liable to Brown in these situations, because both general and qualified indorsers are liable on the following warranties:

- (1) That the instrument is genuine.
- (2) That all prior parties had the necessary capacity.
- (3) That as indorsers, they had good title to the instrument.
- (d) In this situation, Jones only is liable, because a general indorser warrants the validity of the instrument, whereas a qualified indorser warrants only that "he has no knowledge of any fact which would impair the validity of the instrument."

(e) In this situation, Jones only is liable, because a general indorser undertakes that the instrument will be paid at maturity, but a qualified indorser does not.

1470. AI May 1944 (3). (a) *A* makes a note to *B* or order. It is duly indorsed by *B*, *C*, *D*, and *E*, the last indorsing it over to *B*, the original holder. Default and due notice, etc. *B* sues the maker and all the indorsers. Advise all parties. (b) Where a negotiable instrument is ambiguous, what are the rules of construction and interpretation as to:

- (1) Conflict of words and figures.
- (2) Instrument providing for payment of interest without specifying date from which interest is to run.
- (3) Undated.
- (4) Conflict between written and printed provision.
- (5) Instrument containing words "I promise to pay," signed by two persons.

(a) *B* can hold the maker alone. Where an instrument is negotiated back to a prior party, he may reissue and renegotiate it. But he is not entitled to enforce payment of the instrument against any intervening party to whom he was personally liable.

(b) The pertinent rules of construction and interpretation prescribed by the Negotiable Instruments Law are:

- (1) Where the sum payable is expressed in words and also

in figures and there is a discrepancy between the two, the sum denoted by the words is the sum payable, but if the words are ambiguous or uncertain, reference may be had to the figures to fix the amount (see sec. 1459).

(2) Where the instrument provides for the payment of interest, without specifying the date from which interest is to run, the interest runs from the date of the instrument, and if the instrument is undated, from the issue thereof.

(3) Where the instrument is not dated, it will be considered to be dated as of the time it was issued.

(4) Where there is a conflict between the written and printed provisions of the instrument, the written provisions prevail.

(5) Where an instrument containing the words, "I promise to pay" is signed by two or more persons, they are deemed to be jointly and severally liable there. (See sec. 175.)

1471. NY Apr. 1941 (12). By an acceptance, what does the acceptor (a) admit, (b) not admit?

(a) The acceptor admits:

As to the drawer: (1) His existence, (2) the genuineness of his signature and (3) his capacity and authority to draw the instrument.

As to the payee: (1) His existence and (2) his then capacity to indorse.

(b) The acceptor does not admit the genuineness of any part of the draft except the drawer's signature.

(For examples, see sec. 317.)

1472. AI Nov. 1936 (8). Four negotiable promissory notes, payable respectively one, two, three and four months after date, were executed as a part of one transaction; also, as a part of the same transaction, the maker and the payee executed a written agreement that provided that upon default in any one of the notes the remaining ones should immediately become due. Hobbs, to the knowledge of the payee, signed the second and third notes as an accommodation endorser but without either actual or constructive knowledge of the acceleration agreement. The maker defaulted on the first note and thereupon the payee declared all four notes payable and duly notified all endorsers on the first note, of which Hobbs had no knowledge. On the day when the second note matured according to its face, the second note was presented for payment, the maker failed to pay it, and Hobbs was duly notified. Is Hobbs liable as endorser?

Hobbs is not liable as an indorser.

An accommodation indorser, like a surety, is discharged if his risk is altered without his knowledge or consent. Hobbs

indorsed the second and third notes as instruments standing by themselves, due in accordance with their provisions. He did not know of or assent to any arrangement by which such notes might mature sooner than the maturity dates specified in the notes. The agreement to which the notes were subject varied Hobbs' liability without his knowledge or consent. This relieved Hobbs of liability on the notes.

1473. NY Oct. 1937 (4); NY Apr. 1935 (2). (a) What is an accommodation paper?

(b) Can a partner bind his firm by signing such an instrument?

(c) May a corporation execute such a paper for the benefit of a third party?

(a) Accommodation paper embraces any type of bill or note to which an accommodation party, either as maker, drawer, acceptor or indorser, has put his name. "An accommodation party is one who has signed the instrument as maker, drawer, acceptor or indorser, without receiving value therefor, and for the purpose of lending his name to some other person."⁷

(b) A partner cannot bind his firm by signing accommodation paper except (1) with its acquiescence, or (2) by its subsequent ratification, or (3) by estoppel. (See sec. 329.)

(c) A corporation has no power to execute accommodation paper for the benefit of a third party, but it may be estopped from contending that it had no such power (sec. 330).

1474. NY Oct. 1940 (8). A bank acquires a negotiable note as a holder in due course. One of the parties to the note is merely an accommodation party and that fact is known to the bank when it gets the note.

(a) Will that knowledge on the part of the bank prevent the bank's enforcing the note against the accommodation party concerned?

(b) Explain.

(a) The bank's knowledge that one of the parties is an accommodation party is immaterial.

(b) An accommodation party is liable to a holder for value whether the latter, when he acquires the instrument, knows or does not know the accommodation character of prior signatures or indorsements. "The very purpose of the accommodation would be defeated if knowledge of the fact that the responsible party was acting as an accommodator were a good defense in an action by a party who parted with value relying upon the credit of the accommodating party."⁸

⁷ Uniform Negotiable Instruments Act, sec. 29.

⁸ *English v. Schlesinger*, 55 Misc. 584, 105 N.Y. Supp. 989.

1475. AI-NY Nov. 1945 (3). (a) Allen, without receiving any consideration and for the accommodation of Brown, signs a promissory note payable to Brown, who endorses it for value to Cox. When Cox took the note he knew that Allen received no value and was only an accommodation party. Brown is irresponsible and Cox sues Allen on the instrument. Can Cox recover from Allen? If not, why? If so, why?

(b) Amos, who was 17 years old, gave a note in payment for goods to Blue, who endorses it to Coty for value before maturity. The note is not paid at maturity. Coty sues Amos and Blue. Both Amos and Blue set up the infancy of Amos as a defense. Can Coty recover from Amos, or Blue, or both, or neither? Explain.

(a) Cox can recover from Allen. See sec. 1474, subd. (b); also sec. 328.

(b) Coty can recover from Blue but not from Amos. Infancy is a real defense, good against a holder in due course (sec. 334, subd. (c)). Blue, as indorser, is liable on his warranty that all prior parties had capacity to contract (sec. 321).

1476. AI May 1940 (3). *X* was an accommodation endorser for *Y*, the maker of a legally valid, negotiable, promissory note. *Y* failed to pay this note at maturity and *X* became involved in litigation concerning it. Has *X* a valid claim against *Y* for expenses reasonably and necessarily incurred by *X* in that litigation?

X, being an accommodation indorser, has a valid claim against *Y* for expenses reasonably and necessarily incurred in defending the suit. This would not be true if *X* were an indorser for value. "If the endorser (*sic*) of a note be duly fixed, he ought to pay it, without waiting to be sued, but if he finds it more convenient to delay taking up the note, until he is prosecuted to judgment and execution, the drawer ought not to pay for that convenience. It is his own fault or misfortune that subjects him to costs, and he cannot resort to the drawer for indemnity against those costs."⁹ "An accommodation indorser, however, may recover from the maker, the costs incurred in resisting, in good faith, and upon reasonable grounds, a recovery against him upon his indorsement."¹⁰

1477. NY Oct. 1935 (3). Explain the difference between personal defenses and absolute defenses in an action on a negotiable instrument. Give examples of each defense.

Personal defenses are those that are good against any holder except a holder in due course, such as (1) lack of consideration, (2) failure of consideration, (3) breach of contract, (4) coun-

⁹ *Simpson v. Griffin*, 9 Johns. 131-132.

¹⁰ *Overton v. Hardin*, 6 Coldw. (Tenn.) 375, 381.

terclaim or set-off, (5) fraud (in the inducement), (6) duress, (7) blank spaces wrongly filled in, (8) nondelivery (of complete instrument) and (9) payment. Absolute or real defenses are such as can be urged by a person against any holder of a negotiable instrument, including a holder in due course, such as (1) forgery, (2) alteration, (3) incompetence, (4) illegality, (5) fraud (in the execution), and (6) nondelivery (of incomplete instrument).

For a further explanation of the above defenses, together with illustrations, see secs. 333 and 334.

1478. AI May 1940 (12). If a properly drawn and legally valid check is paid by the drawee bank to a swindler who forged the payee's name, what rights, if any, has the payee against the bank?

No rights can arise by such forged indorsement. The payee, however, may not compel the bank to pay him the amount of the check, since a bank is under no contractual duty to him (sec. 376); but the payee may compel the bank to return the check and he may then present the check for payment. If the bank dishonors the instrument by refusing to pay it, the payee may hold the drawer (sec. 376).

1479. AI Nov. 1942 (9). X was induced by fraud to draw a check to the order of an existing person whose name and identity had been fraudulently assumed by an impostor, and to deliver this check to the impostor. The impostor thereupon endorsed the check in the name of the payee and cashed it.

(a) Was this endorsement a forgery?

(b) On the assumption that it was a forgery, what rights and obligations has the bank that paid the check?

(a) The indorsement was not a forgery. (See sec. 386, Example (1) and 334, subd. (A), "Indorsement by impostor v. indorsement by thief or swindler").

(b) If the indorsement had been a forgery (see secs. 1478 and 334, subd. (A), "Indorsement by impostor v. indorsement by thief or swindler"), the bank could have recovered the amount of the check from the impostor, and the drawer, if his account had been charged with the payment, could have compelled the bank to credit his account with the amount of the check. Payment on a forged indorsement is payment without the drawer's authority, and a bank has no right to pay a drawer's check except to the drawer's order.

1480. AI Nov. 1935 (7). In what respects must a negotiable instrument be changed in order that the change will constitute a material alteration?

Any alteration is material that changes (1) the date, (2) the sum payable, (3) the time or place of payment, (4) the number or relation of the parties or (5) the medium of payment; or that (6) adds a place of payment where none is specified, or (7) alters the effect of the instrument in any respect.

1481. AI-NY Nov. 1944 (2). (a) Abbott gives his note to Brown, no interest being specified. Brown adds thereto a provision for interest and conveys the note for value before maturity to Coffey, who takes it without notice. Can Coffey enforce the note against Abbott for principal and interest? What is Coffey's position? Discuss fully.

(b) Andrews, holder of a note on which there are six indorsements, strikes out the second and third. Thereafter he sues Hanson and Young, who are the fourth and fifth indorsers respectively on the note, which has been dishonored. Can he recover? State the rule.

(c) Anthony drew a check on the X Bank for \$1000 and delivered it to Belton for value, who indorsed it to Collins for value. Collins had the X Bank certify it. All transactions took place in a reasonable time. The day after the certification, the X Bank failed. Anthony and Belton both have ample means. What is Collins' position with regard to Anthony, Belton and the X Bank? Give reasons for your answer.

(a) Coffey may enforce the note against Abbott for principal only. The material alteration of an instrument binds only those who assented to the alteration or who, by indorsing the instrument, warrant its regularity and genuineness. However, though even a holder in due course may not enforce such alteration against a maker or drawer who did not assent to it, he may enforce the instrument "according to its original tenor," in this case, the original face amount without interest. (See sec. 334, subd. (B)).

(b) Andrews cannot recover. Where the holder strikes out an indorsement not necessary to his title, the indorser whose name is stricken out and *all subsequent indorsers* are discharged.

(c) Collins has no recourse against Anthony and Belton. Where the *holder* of a check procures it to be certified, the drawer and indorsers are discharged from further liability (sec. 379). However, Collins would have a preferred position with respect to the bank. Certification constitutes an equitable assignment of the drawer's funds, which are charged ac-

cordingly. If the bank fails after certification and before payment, its assets are impressed with a trust in favor of the payee to the amount of the check, and the payee has a corresponding preference.

1482. AI May 1939 (4). Black made and delivered a legally valid promissory note, entirely in his own handwriting, payable at "No. 22 Mira Vista Ave.," which was his residence. The note was transferred several times by endorsement, and someone without authority added "People's Trust Co." in printed characters on the face of the note directly under the handwritten designated place of payment. Thereafter, but prior to maturity, Brown acquired the note by purchase for value and without actual knowledge of the alteration. At maturity, Brown presented the note at the People's Trust Company, which was not at the stated address, and the note was not paid. Can Brown recover from Black on this note?

Brown cannot recover from Black on this note.

The unauthorized addition of the words "People's Trust Co.," since it purported to change the place of payment, constituted a material alteration (sec. 334, subd. (B)). A material alteration, with certain exceptions (sec. 334, subd. (B)) voids the instrument, except as to a holder in due course, who may enforce the instrument against the maker or drawer, but only in accordance with its terms before the instrument was altered. Unless Brown is a holder in due course, the note is void in his hands, so far as concerns the maker. Brown is not a holder in due course because, when he acquired the instrument, it was not "complete and regular on its face" (sec. 308, subd. (1)), due to the following irregularity: The words "People's Trust Co." appeared in *printed* characters on the face of the note directly under the *handwritten* designated place of payment.

1483. AI Nov. 1941 (7). (a) When a negotiable promissory note falls due on a Friday that is a legal holiday, when does it become payable?

(b) When a negotiable promissory note is payable on demand, can the holder legally present it for payment on a Friday that is a legal holiday? If not, what is the earliest time thereafter when it can be so presented?

(c) When a negotiable instrument is payable 90 days after date, after sight, or after the happening of a specified event, how, exactly, is the date of payment determined?

(d) What circumstances make defective the title of a person who negotiates a negotiable instrument?

(a) The following Monday (see sec. 347).

(b) No negotiable instrument, whether payable on demand or otherwise, may be presented for payment on a legal holiday,

but the Negotiable Instruments Law provides that "instruments payable on demand may, at the option of the holder, be presented for payment before twelve o'clock noon on Saturday when that entire day is not a holiday." Hence, the earliest time after Friday when the holder can legally present the instrument for payment is Saturday morning.

(c) When an instrument is payable a given number of days after date, or after sight, or after the happening of a specified event, the date of payment is determined by excluding the day or event from which the time is to run, and by including the day of payment.

(d) The Uniform Negotiable Instruments Act provides¹¹ that: "The title of a person who negotiates an instrument is defective within the meaning of this act when he obtained the instrument, or any signature thereto, by fraud, duress, or force and fear, or other unlawful means, or for an illegal consideration, or when he negotiates it in breach of faith, or under such circumstances as amount to a fraud."

1484. NY Apr. 1944 (3). In the following circumstances, state the respective rights and obligations of (a) the maker, (b) the payee, (c) the holder, (d) the bank:

John Smith gave his promissory note for \$1000, due February 15, 1944, payable at the Citizens Bank, to Henry Brown, who, for value, endorsed and delivered it to William Jones. Through an oversight, it was not presented for payment until February 25, 1944, when, as on February 15 and thereafter, Smith had more than \$1000 on deposit in the Citizens Bank.

(a) The maker is liable notwithstanding Brown's failure to make presentment on due date. Presentment for payment is necessary to charge parties secondarily liable only. The primary parties (maker of note and acceptor of bill) remain absolutely liable in any event, regardless of due presentment.

(b) The payee is not liable as an indorser. Such liability was conditioned on the making of due presentment, and a failure to make such presentment discharged Brown from further liability (sec. 346).

(c) The holder may recover the face amount of the note, without interest. The maker need not pay interest accruing after maturity if he was ready, willing and able to pay his note at the proper time and place. By making the note payable at the bank, Smith in effect directed the bank to pay it upon

¹¹Sec. 55.

proper presentment (sec. 349), and he had the necessary funds on deposit with which to pay the instrument. Nonpayment on due date was the holder's fault, not Smith's, hence the holder may collect no interest.

(d) Had the note been presented on due date, the bank would have been authorized but not obligated to pay it; at least, such obligation would not run to the holder (with whom the bank had no contractual relationship) but to the depositor, whose orders against his account the bank is under a duty to honor (sec. 376). The Negotiable Instruments Law provides that where the instrument is payable at a bank, presentment for payment must be made during banking hours, unless the person to make payment has no funds there with which to meet it at any time during the day, in which case presentment at any hour before the bank is closed on that day is sufficient. The bank's authority to pay the note would not survive beyond the day of due presentment. Hence if, on February 25, 1944, the bank paid the note without further specific authority from the maker to do so, it would be liable to the maker for the amount of the unauthorized payment. The fact that the maker is liable to the holder notwithstanding nonpresentment would not excuse the bank for paying out the maker's funds without his authority.

1485. AI May 1937 (9). (a) In what circumstances and for what purpose is it necessary to protest a negotiable instrument?

(b) Describe the procedure by which a legally valid protest is made.

(a) Only foreign bills of exchange (sec. 281), including checks, need be protested, though other instruments are often protested as a matter of business practice. Proof of presentment and dishonor is sometimes difficult where an instrument is drawn and payable in different states. Protest facilitates proof, because certificates of protest under the seal of a notary are commonly made "self-proving" by statute. (See sec. 356.)

(b) Say a draft is forwarded by the *A* Bank in Chicago to the *B* Bank in New York, for collection. At maturity, the *B* Bank gives the draft to its notary public (usually an employee), who presents the instrument to the proper person (often another bank) at the proper time and place and demands payment. Assuming nonpayment, the notary then "protests": He notes the fact of dishonor, and makes out a certificate of protest dated on the date and at the place of dis-

honor, and then signs it and affixes his notarial seal. The certificate must be attached to the defaulted instrument or a copy of it, and it must set forth: (1) Time and place of presentment, (2) fact and manner of presentment, (3) basis of dishonor (nonacceptance or nonpayment), (4) the fact of demand made, (5) the answer given (insufficient funds, no account, no instruction to pay, and so on), (6) a formal declaration of the fact of dishonor, and (7) formal words of protest to secondary parties. Notice of protest is then sent to parties secondarily liable.

Protest may be made by a person other than a notary, before two or more witnesses (see sec. 356).

1486. AI-NY May 1945 (1). Fox, for value, gives a promissory note to Amos and Bell, partners, who indorse the note to Cody before maturity. Fox fails to pay the note at maturity and Cody, the holder, gives notice of dishonor to Amos only. The firm of Amos and Bell had been dissolved by mutual consent before maturity of the note, which fact the holder, Cody, knew, and Amos had become financially irresponsible. The holder, Cody, seeks to recover from Bell, who disclaims liability for want of legal notice. Can Cody recover from Bell? Why?

(b) (1) What is a restrictive indorsement of a negotiable instrument?
(2) Is there more than one class or type of restrictive indorsement? If so, what are they?

(3) Does restrictive indorsement destroy the negotiability of the instrument?

(4) Give a common example of restrictive indorsement.

(5) What are the rights of an indorsee who receives a negotiable instrument with a restrictive indorsement?

(a) Cody can recover from Bell. Where the indorsers are partners, notice to any one partner is notice to all, though the firm is dissolved. (See sec. 359, *Partners and joint parties*.)

(b) (1) A restrictive indorsement is one that "restrains the negotiability of the instrument to a particular person or for a particular purpose."¹² It (a) prohibits further negotiation, or (b) makes the indorsee the indorser's agent, or (c) vests title in the indorsee in trust for or to the use of another.

(2) A restrictive indorsement may be either in blank or special. (See sec. 305.) *Examples:*

Restrictive, in blank: "For deposit only. William Blake."

Restrictive, special: "Pay to the order of Transcontinental Trust Company, for deposit only."

(3) A restrictive indorsement does not destroy the negotia-

¹² 10 *Corpus Juris Secundum* 704.

bility of an instrument. It merely restricts negotiability by prohibiting further negotiation or by limiting negotiability to a particular purpose. (See subd. (b) (1).)

(4) For three common examples of a restrictive indorsement, see sec. 301.

(5) The Uniform Negotiable Instruments Act provides¹³ that a restrictive indorsement confers upon the indorsee the right (1) to receive payment of the instrument; (2) to bring any action thereon that the indorser could bring; and (3) to transfer his rights as such indorsee, where the form of the indorsement authorizes him to do so. It further provides: "But all subsequent indorsees acquire only the title of the first indorsee under the restrictive indorsement."

1487. **AI May 1935 (6).** Edward Engle and several other members of a club had endorsed a note made by the club. The club failed to pay the note and the payee procured from the president of the club a list of names and addresses of endorser. This list was typewritten on club stationery that showed Engle's name as secretary and his address. The payee attempted to verify the addresses by examining the current telephone directory in which he found an Edward Engle at an address different from the one on the club stationery. Within the legally proper time, the payee sent a notice in legally proper form to Edward Engle by registered mail at his address as stated on the club stationery. Two days later the post office returned this notice with a notation "Moved, left no address." Was the payee's notification of Engle sufficient to hold Engle as endorser?

The question whether the payee's notification of Engle was sufficient to charge him as an indorser would depend upon whether the payee used due diligence in ascertaining the indorser's address. Was it due diligence or not, to accept the address given on the list furnished by the president of the club, in the face of an apparently different address given in the telephone directory, or should the payee have followed the matter up further in view of the contradictory information? This would be a question of law to be decided by the Court, since the facts themselves appear to be undisputed. "But in case the holder does not actually know the indorser's place of residence, the notice may be addressed to the place where, after diligent inquiry, he is informed and believes he resides. What is due diligence in such case, the facts being undisputed or ascertained, is a question of law."¹⁴ Where reasonable and

¹³ Sec. 37.

¹⁴ *Requa v. Collins*, 51 N.Y. 144, 147.

prompt diligence is exercised in endeavoring to ascertain an indorser's correct address, the holder will be excused, though he acts on incorrect information thus obtained.¹⁵

A court might reasonably hold that the payee was on notice that the address on the club list was not the latest address and that due diligence required a copy of the notice to be sent to the address shown in the telephone directory.

1488. AI May 1936 (9). Formal notice of presentment and dishonor of a promissory note was not mailed or otherwise given to an endorser. Upon the trial of an action brought against him, the testimony showed that the endorser had said to at least one witness that the maker "is having trouble with his creditors and I don't believe he will be able to meet this note at maturity." It further appeared that the endorser had arranged with the maker a plan whereby the maker could pay the note in installments. Is the defense of lack of notice an effective bar to the action against the endorser?

The defense of lack of notice is an effective bar to the action. Indorsers are entitled to notice of presentment and dishonor except (1) when it is dispensed with (sec. 366), (2) when it is not required (sec. 368) and (3) when it is waived (sec. 370).

Situations (1) and (2) are not applicable here.

Neither is situation (3) applicable to the facts. Waivers may be express or implied. There was no express waiver by this indorser. Neither was there an implied waiver, because mere knowledge by an indorser of a maker's actual or prospective inability to pay does not of itself spell out a waiver (sec. 370). Neither did the plan for installment payments arranged between the indorser and the maker constitute an implied waiver by the indorser of his right to receive notice from the holder.

Failure to give the indorser notice discharged him from liability on the note.

1489. AI Nov. 1939 (6). A corporation duly executed and issued a legally binding negotiable promissory note, on which the president of the corporation was an accommodation indorser. Prior to maturity of the note, the president initiated and conducted bankruptcy proceedings for the corporation with the result that when the note matured the corporation was without funds, its business suspended, its place of business closed, and its property in the hands of a receiver. Upon due presentation of this note, the corporation failed to pay it but no notice of dishonor was given to said

¹⁵ *Whitridge v. Rider*, 22 Md. 548; *Singac Trust Co. v. Soschin*, 11 N.J. Misc. 37, 164 A. 869.

indorser, who still was president. Can the president be held liable on his indorsement? What rule or principle of law is involved?

The president can be held liable on his indorsement. The mere fact that he was an accommodation indorser would be immaterial to his right as an indorser to receive notice. Also, mere knowledge by an indorser of a maker's actual or prospective inability to pay, or even his insolvency or bankruptcy,¹⁶ does not of itself spell out a waiver (secs. 370 and 1488). Here, however, there was more than mere knowledge. "Prior to the maturity of the notes the maker had been adjudicated a bankrupt, and the adjudication was based at least in part upon the written admission of the defendant of its inability to pay debts, coupled with a willingness that it be adjudged a bankrupt. It is true the defendant signed this admission in his official capacity as president of the corporation, while he is only liable as indorser as an individual; but as an individual he knew when the notes fell due that the corporation could not pay them, because it had then been adjudicated a bankrupt and all of its property was in the hands of a receiver in the bankruptcy proceedings, in which he participated. Under such circumstances the defendant must be deemed to have waived, at least impliedly, within the meaning of the sections of the negotiable instruments law above referred to, presentment of the notes and notice of dishonor."¹⁷

1490. AI May 1935 (3). The maker of a valid promissory note legally procured defendant's endorsement prior to delivery of the note to the payee. Prior to maturity, the payee orally agreed with defendant and with the maker to release defendant as endorser and in consideration therefor defendant turned over certain valuable property to the payee. There was no written renunciation by the payee of his rights against defendant as endorser and the note was neither surrendered nor in any way marked or altered. Was defendant released as endorser so far as the payee is concerned?

The defendant was released as indorser so far as the payee was concerned. Ordinarily, an oral renunciation would be ineffective "unless the instrument is delivered up to the person

¹⁶ *Calkins v. Vaughan*, 217 Ala. 56, 114 So. 570; *Christina v. Mattenberger*, (Cal. App.), 289 P. 934, affirmed 212 Cal. 670, 300 P. 450; *Moriarty v. Howard*, 258 Ky. 629, 80 S.W. 2d 526; *Robinson v. Lancaster Foundry Co.*, 152 Md. 81, 136 A. 58; *Haynes Automobile Co. v. Shepherd*, 220 Mich. 231, 189 N.W. 841; *Barton v. Baker*, (Pa.), 1 Serg. & R. 334, 336; *Horton v. Bolding*, (Tex. Civ. App.), 67 S.W. 2d 435; *Black v. Emporium Dry Goods Co.*, 129 Wash. 100, 224 P. 591.

¹⁷ *J. W. O'Bannon Co. v. Curran*, 129 App. Div. 90, 113 N.Y. Supp. 359.

primarily liable thereon" (Negotiable Instruments Law, sec. 122). However, this transaction represented an executed agreement between payee and defendant, upon sufficient consideration, to discharge the defendant so far as the payee is concerned, and the payee is bound by such agreement.¹⁸ In *Bank of United States v. Manheim*,¹⁹ the Court says, in reference to the above quoted provision of the Negotiable Instruments Law: "This language seems plain and clear, in so far as some kind of a writing is required, *in the absence of consideration* or of delivery of the instrument to the person primarily liable." The Court then goes on to say that the provision in question "requires a written renunciation only when no consideration passes. One who orally promises to renounce and does in fact accept a thing of value in exchange for such promise must be deemed to be estopped in the same degree as any other party affected by a statute of frauds where there has been full performance. * * * A negotiable instrument, like a simple contract for the payment of money * * * may be discharged by oral agreement supported by an executed consideration. No inference is warranted that a similar method respecting renunciation of rights against an indorser would not be efficacious."

1491. **AI May 1938 (4).** (a) Define a check drawn on a bank.

(b) Within what time should a check be presented for payment, and what is the legal effect upon any of the parties thereto of a failure to present it within that time?

(c) What is the legal effect of the certification of a check by the bank on which it is drawn?

(d) If the holder of a check procures its certification, how are the other parties thereto affected?

(a) A check is a bill of exchange drawn on a bank and payable on demand.

(b) The Negotiable Instruments Law provides that: "A check must be presented for payment within a reasonable time after its issue or the drawer will be discharged from liability thereon to the extent of the loss caused by the delay." The usual cause of such loss is insolvency of the bank after the check is issued and before it is presented. (See sec. 377.)

¹⁸ *McGlynn v. Granstrom*, 169 Minn. 164, 210 N.W. 892; *Jones v. Wettlin*, 39 Wyo. 331, 271 P. 217; *Hall v. Wichita State Bank & Trust Co.* (Tex. Civ. App.), 254 S.W. 1036; *Gorin v. Wiley*, 215 Ill. App. 541.

¹⁹ 264 N.Y. 45.

(c) Certification of a check corresponds to the acceptance of a bill. It makes the drawee bank primarily liable to the holder, who otherwise has no claim upon the bank (sec. 376). Like any other acceptor, the certifying bank not only engages to pay the instrument according to its terms, but guarantees the genuineness of the drawer's signature and his capacity and authority to draw the instrument. Certification, however, goes further than an ordinary acceptance; it warrants that funds on deposit are sufficient to pay the check and are being set aside for such purpose. (See sec. 378.)

(d) If the holder of a check procures its certification, the drawer and all indorsers are discharged from liability. (See sec. 379.)

1492. **NY Apr. 1941 (1).** In a bank's relations to the general public, its responsibilities and rights, unless specifically provided for by statute, are governed by general rules of law as to agency, contracts, interest, negotiable instruments, and so on.

(a) Is a bank liable to the holder of a check before it certifies it?

(b) Are the drawer and indorsers of a check liable upon it after the bank upon which it is drawn has later certified it?

(c) After the death of a depositor, may or must the bank honor checks that were issued by him before his death?

(d) After the death of one of the depositors in joint account, may or must the bank honor the checks of a surviving depositor as it did before the death of the other?

(a) A bank is not liable to the holder of a check before certification (sec. 376).

(b) The drawer and indorsers of a check are discharged only where the *holder* procures it to be certified (sec. 379). Where the *drawer* procures it to be certified, he remains liable notwithstanding such certification.

(c) After the death of a depositor, the bank is neither required nor authorized to honor checks issued by the depositor before his death, because the death of a drawer automatically revokes any of his outstanding drafts upon his account. However, a bank is not liable for payment of a check after the drawer's death if it had no reasonable opportunity to ascertain the fact of such death. In some states, banks are given a period of grace after a depositor's death within which they may honor his checks though they know him to be dead.

Though payment by the bank under these circumstances does not render the bank liable to the estate, such payment

made without the authority of an existing drawer remains unauthorized, and the estate may sue the payee of the check for the amount of the unauthorized payment. If the check was given in payment of a legitimate claim against the decedent, such claim, unpaid by the drawer while alive, would remain a legitimate claim against the estate and could be set off against any claim by the estate for the amount of the check. (See sec. 385.)

(d) Where a joint bank account is opened in form prescribed by statute, the death of one of the depositors automatically passes the exclusive right in the account to the survivor.²⁰ If the bank is without knowledge of the death and has not had a reasonable opportunity to learn of it, the bank may honor the survivor's check without liability to the estate or to third parties having claims against the estate. If, however, the bank has knowledge of the death of one of the joint depositors, the law in New York and other states requires that it must make no payment to the survivor except upon prior notice to the tax authorities. Although under the federal and various state laws the interest of a joint depositor automatically passes on his death to the survivor, it is nevertheless subject to payment of a transfer tax.²¹

1493. NY Oct. 1943 (3). *A* has an ordinary checking account in a bank, with a credit balance of \$2000. He owes *B* \$1000 and gives him a check for that amount on the bank, which the bank declines to pay.

(a) Among *A*, *B* and the bank, who then is indebted to whom?

(b) Give reasons for your answer.

(a) *A* is indebted to *B* in the amount of the check, and the bank is liable to *A* for any damage to *A*'s credit resulting from its refusal to pay his check.

(b) Since the drawer of a bill engages that on due presentment the instrument will be paid, refusal of the bank to pay the check renders the drawer, *A*, liable to the holder, *B* (sec. 319).

The bank is not liable to *B*, the holder, because it owes no duty to *B*, contractual or otherwise (sec. 376). Its duty is to *A*, its depositor and creditor, whose checks up to the amount of his account the bank is obliged to honor. For an unwar-

²⁰ *In re Juedel's Will*, 280 N.Y. 37.

²¹ However, to the extent that the survivor originally contributed to the decedent's interest, such interest is not taxable.

ranted refusal to pay a depositor's check, the depositor may hold the bank to the extent of provable damages sustained in consequence of such refusal. In the case of business accounts, the damage is likely to be greater (because of the effect on his credit) than in the case of a deposit for personal convenience. The rule of damages in such cases is not uniform. In New York (this being a New York question), in the absence of proof of special damages, only nominal damages (sec. 239) will be permitted if the bank's refusal is not shown to be willful or malicious, as where it is the result of an innocent mistake. However, where the refusal is deliberate and willful, substantial damages may be inferred if the depositor is a businessman, but not otherwise.²²

In other states, the common law rule prevails that damages may be inferred from the mere fact of wrongful dishonor,²³ although some states follow the rule only where the depositor is a merchant or a trader.²⁴

1494. NY Oct. 1942 (2). Shortly before the close of banking hours on Saturday before Labor Day, a creditor receives from his debtor two checks, one of which has been certified before its delivery to the creditor. Certification of the other check is secured by the creditor but too late for the deposit of either check in the creditor's bank until after Labor Day. At this time the bank on which both checks were drawn does not open for business and has been taken over by the Banking Department.

State the position of the creditor with regard to each check, giving reasons therefor.

The creditor may hold the debtor on the first check, but as to the second, the drawer is discharged. Where the *holder* procures a check to be certified, the drawer and indorsers are discharged, but where the *drawer* procures the certification, he

²² 9 *Corpus Juris Secundum* 780, citing *Wildenberger v. Ridgwood Nat. Bank*, 230 N.Y. 425; *Wahrman v. Bronx County Trust Co.*, 246 App. Div. 220, 285 N.Y. Supp. 312; and *Katz v. Pacific Bank*, 212 App. Div. 601, 209 N.Y. Supp. 497.

²³ *McFall v. First Nat. Bank of Forrest City*, 138 Ark. 370, 211 S.W. 919; *Few v. First Nat. Bank*, 40 Ga. App. 791, 151 S.E. 546; *Grenada Bank v. Lester*, 126 Miss. 442, 89 So. 2; *American Nat. Bank v. Morey*, 113 Ky. 857, 69 S.W. 759, 760; *Woody v. National Bank of Rocky Mount*, 194 N.C. 549, 140 S.E. 150, 154; *Patterson v. Marine Nat. Bank*, 130 Pa. 419, 18 A. 632, 633; *Ward v. State Bank of Yates*, 52 Mont. 328, 157 P. 573.

²⁴ *Friedman v. Edgewater State Bank*, 215 Ill. App. 36; *Caudle v. Eliasville State Bank*, (Tex. Civ. App.), 93 S.W. 2d 779; *Browning v. Bank of Vernal*, 60 Utah 197, 207 P. 462.

remains liable if the bank fails or refuses to pay. See sec. 379, Example (1).

1495. AI May 1940 (9). A certified public accountant who had completed his professional work for an out-of-town corporate client, delivered his report to the president of the corporation in the latter's office. The president thereupon told him that the corporation's check for his fee would be given to him in half an hour and that the accountant could have it certified on his way to the railroad station, or, if the accountant preferred, a check already certified would be given to him in three-quarters of an hour. Disregarding entirely all matters of personal convenience, which offer should the accountant accept?

The accountant should accept the offer of a check certified by his client. Should the bank fail after certification, the corporation would remain liable if it had procured the certification but would be discharged if certification was procured by the accountant. (See secs. 379 and 1494.)

1496. AI Nov. 1938 (1). The legal holder of a properly drawn check presented it to the bank on which it was drawn and demanded that the bank certify it, which the bank refused to do. At no time was the check presented for payment, but, within what would have been a reasonable time for such presentation, the holder formally notified the drawer that certification had been refused and demanded that the drawer pay the amount of the check. On the facts stated, must the drawer immediately pay the holder?

The bank's refusal to certify does not render the drawer liable to the holder. Unlike ordinary bills, checks are payable on demand and are usually issued for such purpose. A bank is obligated to *pay* checks on presentment, it is not obligated to certify them. Refusal to certify does not constitute dishonor, hence it does not render the drawer liable. (See sec. 380.)

1497. AI May 1938 (9). On a Saturday afternoon, X signed a check for \$7000 and gave it to the payee as a gift. On the next day, X was killed in an accident. On the following Monday morning, the payee cashed the check at the bank on which it was drawn, said bank having neither actual nor constructive notice of X's death.

(a) Can X's estate recover from the bank the amount of this check?

(b) Can X's estate recover the amount of it from the payee?

(a) X's estate cannot recover the amount of the check from the bank. See sec. 1492, subd. (c).

(b) X's estate can recover the amount of the check from the payee. The check did not constitute a gift of the money but

only of an order for the money, since the order, or check, did not constitute an assignment of the funds. The gift therefore lacked delivery and was revocable, either by the drawer before his death or by his estate after his death. (See example in sec. 385, "Right to recover proceeds from payee.")

1498. AI and NY Nov. 1944 (11). (a) What are the duties of the depositors to examine returned checks and what is the result if they fail to do so?

(b) What are the obligations of a depositor to examine bank statements of his accounts?

(c) What is the legal effect of a bank's certifying checks of its depositors?

(d) What is the bank's liability on certified checks?

(e) When does and when does not certification of a check discharge the drawer?

(a) Depositors must examine returned checks without unreasonable delay. What constitutes unreasonable delay may be fixed by statute in the case of both forged signatures and forged indorsements (sec. 387), although, in the absence of statute, a depositor is not required to ascertain whether indorsements are genuine or false.

(b) Where banks furnish depositors with statements of their accounts, it is the duty of the depositor to examine them without unreasonable delay. If he fails to do this, the account will be deemed correct in the absence of fraud or concealment (sec. 387).

(c) See sec. 1491, subd. (c).

(d) See sec. 1491, subd. (c).

(e) Certification discharges the drawer when it is procured by the holder, but not when it is procured by the drawer.

CHAPTER IV-A

Sales

- 1499. NY Oct. 1940 (3).** (a) Give the title of the law governing sales.
(b) What are essentials of a transaction of sale?
(c) Is transfer of possession an essential?
(d) What are future goods?
(e) What are unascertained goods?
(f) What are specific goods?
(g) What are fungible goods?

(a) The law governing sales is commonly referred to as the Sales Act; in the large majority of states (see table on pages 12-13) it is based on the Uniform Sales Act.

(b) The essentials of a sales transaction correspond to those of any other contract, whether executed (as in a sale) or executory (as in a contract to sell). There must be (1) parties having capacity to contract, (2) consideration (price), (3) subject matter (possessing not only validity, but actual or potential existence), and (4) mutual assent (including intent to pass title).

(c) Transfer of possession is not essential to the validity of a sale or contract to sell.

(d) Future goods are goods which are not yet in existence, or which the seller does not yet own. (See sec. 400.)

(e) Unascertained goods are goods not yet selected or in existence, such as a lot of 500 dresses ordered by the buyer subject to his selection, or a lot of 500 suits of clothes to be made up on specifications to be furnished by the buyer.

(f) Specific or ascertained goods are goods selected or set aside, either by the buyer, or by the seller with the buyer's consent.

(g) Fungible goods are goods consisting of a uniform mass, no part of which can be ascertained or sold except by weight or measure, such as peas, beans, oats, wheat, corn, barley, flour, wine, oil, gasoline, sand or bricks.

1500. NY Oct. 1941 (14). (a) Define sale.

(b) Define exchange.

(c) Explain what difference in legal effect, if any, there is between a sale and an exchange.

(d) Two industrials own leaseholds, each originally for twenty years. Neither industrial is using its own leasehold but each could make use of that belonging to the other and wishes to do so.

X Corporation's lease cost \$20,000 six years ago.

Y Corporation's lease cost \$25,000 eight years ago.

They propose to exchange these leaseholds without fixing a price upon either and without passing any boot either way. Is there any provision of law to prevent their doing this?

(a) A sale is a transaction wherein the owner of personal property transfers title therein to the buyer for a consideration called the price.

(b) An exchange is the transfer of title in one chattel for title in another.

(c) There is no difference in legal effect between a sale and an exchange. The law governing sales (including the statute of frauds) governs exchanges as well. The only actual difference between the two is in the consideration given for the chattel; money in a sale, another chattel in an exchange.

(d) There is no provision of law to prevent the consummation of this transaction. However, if the arrangement is not evidenced by a written memorandum signed by the party to be charged, such party may with impunity refuse to consummate the transaction. Long term leaseholds are neither contracts of sale nor *choses in action*.¹ Hence, although the transaction involves an exchange of values obviously in excess of the minimum value allowed by the statute of frauds for oral contracts of sale of personal property, this transaction involves neither a sale nor an exchange of *personal* property. The transaction is, however, governed by the provision of the statute of frauds which requires contracts for the sale (including exchange) of any interest in real property (except leases for not more than one year) to be evidenced by a writing (sec. 184).

1501. AI Nov. 1943 (8). (a) What is the difference between a sale and a contract to sell?

(b) What is the rule as to title where goods are delivered "on sale or return"?

(c) A purchased goods from B on the understanding that B should take back any goods unsold at the end of the season. During the season the

¹ *Davis v. Investment Land Co.*, 296 Pa. 449.

goods were destroyed by fire without fault of A. By whom must the loss be sustained? Explain.

(a) In a sale, the seller *transfers* title in goods; in a contract to sell, the seller *agrees to transfer* title in goods. The difference is between an executed sale and an executory sale, respectively.

(b) Title to goods sold "on sale or return" passes immediately, but may revert in the seller at the buyer's option exercised within the time fixed in the contract, or, if no time has been fixed, within a reasonable time.

(c) The loss falls on A, since he was the owner of the goods when the fire occurred. The goods in question were delivered "on sale or return."

1502. AI May 1936 (5). What is the difference between a sale and a contract to sell and of what importance is the distinction?

For the difference between a sale and a contract to sell, see section 1501. The importance of the distinction lies in the fact that a sale is void if it purports to sell future goods (sec. 400), since one cannot transfer, *now*, title to something that does not now exist, or that one does not now own (lack of subject matter); whereas a contract to sell future goods is entirely valid. Again, the distinction may become important when the goods in question are lost, damaged or destroyed without fault of either party during the course of a sale or contract to sell. In a sale, title passes immediately and the buyer stands the loss in the first instance, since he is the owner, and risk follows ownership. In a contract to sell, title may or may not have passed. In the former case, the buyer stands the loss in the first instance; in the latter, the seller.

1503. NY Apr. 1943 (4). A merchant bought seasonal goods from a manufacturer under an agreement that the manufacturer would accept the return of any goods which the merchant had not sold at the end of the present season.

(a) Was this sale or a consignment?

(b) If before the end of the season the goods were destroyed by fire, would the loss fall on the merchant or on the manufacturer?

(a) The transaction was a sale, not a consignment. The goods were sold "on sale or return."

(b) The loss would fall on the merchant, since he was the owner of the goods when the loss occurred (see sec. 1501, subd. (c)).

1504. NY Oct. 1940 (10). In law and general dictionaries the word "consignment" is shown to have two meanings about as follows: (1) the act of delivery of goods to a second person for transportation, (2) the goods so delivered to a third person.

(a) How would you designate the two parties involved in (1) just mentioned?

(b) How would you designate the three parties interested in (2) just mentioned?

(c) Under what heading of commercial law would you look for general rules as to the respective rights and obligations of the party by whom the goods were delivered for transportation and the party by whom the goods were received after transportation?

(a) The two parties involved in (1) above are *shipper* and *carrier*.

(b) The three parties interested in (2) above are *consignor*, *carrier* and *consignee*.

(c) The general rules as to the respective rights and obligations of the party by whom the goods were delivered for transportation (the shipper) are embraced in the law of carriers. The corresponding rules of law governing the rights and obligations of the party by whom the goods were received after transportation (the consignee) are embraced in the law of sales, except that any questions involving the consignee's rights and obligations with respect to the carrier would be embraced in the law of carriers.

1505. NY Apr. 1935 (11). What is the difference between a sale and a consignment? If a consignee converts to his own use the proceeds of the sale of a consignor's goods, may an action be maintained for the goods?

A sale transfers title, whether possession be immediately transferred or not. A consignment, ordinarily, does not pass title, but merely transfers possession to the consignee, with power in the latter to transfer title, either in his own name, or in the name of the consignor, depending upon custom or the contract between the parties.

A consignee, as a rule, is vested by the consignor with the evidences or "indicia" of title; that is, the consignor, by his own act, usually gives the consignee the appearance of having title. Hence if a consignee converts to his own use the proceeds of the sale of a consignor's goods, he is liable for such proceeds to the consignor. The purchaser of the goods, however, gets good title, and the consignor may not maintain an action against him for the goods. "Where one of two innocent parties (consignor and purchaser) must suffer for the wrong of

another (consignee), he who made the wrong possible (consignor) must suffer."

1506. AI May 1943 (10). *X* gave *Y* a written statement that *X* had sold to *Y* 15,000 pounds of yarn "at a price to be determined between us, subject to market fluctuations, to be not less than \$1.27½ in the event of decline or more than \$1.32½ in the event of advance." Does this constitute (1) a sale, or (2) a contract of sale?

This transaction constitutes neither a sale nor a contract of sale, since it lacks the essential of an ascertained or ascertainable price. A contract which provides that the parties are to agree on a price later is unenforceable, because the minds of the parties have not completely met, and may never meet. If the parties had excluded the words "at a price to be determined between us," the price might have been ascertainable, since the agreement in such event would evidence an intention to accept the market price at a given time as the price of the goods in question, within the maximum and minimum ranges specified.

1507. AI May 1939 (8). State and illustrate by brief examples the difference between a contract of sale and a contract for work, labor, and services, and explain the importance, legally, of differentiating between them.

A contract of sale is one for the purchase of goods in the normal course of trade. The essence of the contract is the transfer of title to the goods. A contract for work, labor and services is not one for the transfer of title, but for effort bestowed, though the result be to create or service a chattel for sale.

The importance, legally, of differentiating between the two transactions lies in the applicability of the statute of frauds. A contract of sale of personal property of a value higher than the amount allowed for oral contracts under the statute of frauds is unenforceable unless it is evidenced by a writing, or unless there is part payment or part delivery at the time of making the contract (secs. 182, 188 and 402). This provision of the statute of frauds, however, is not applicable to contracts for work, labor and services, such as manufacturing contracts. Under the Uniform Sales Act a contract to sell goods which are to be manufactured by the seller especially for the buyer, and which are not suitable for sale to others in the ordinary course of the seller's business, is viewed as a contract for work, labor

and services, and not as a contract of sale; and such a contract, regardless of the amount involved, is not required by the statute of frauds to be evidenced by a writing.

1508. NY Oct. 1937 (13). A manufacturer in Ohio ships to a man in New York State merchandise either "on approval" or "on sale or return." When does ownership of the merchandise pass to the man in New York State?

The ownership of the merchandise shipped on approval passes to the man in New York State when he signifies his approval. If the goods were shipped "on sale or return," the ownership would pass immediately, but might revert in the seller, at the buyer's option, provided such option were exercised within the time fixed in the contract, or, if no time had been fixed, within a reasonable time.

1509. AI May 1941 (8). *X* enters into a legally valid contract to buy from *Y* certain specifically identified goods then in a public warehouse.

(a) If, without the knowledge of either party, said goods had been completely destroyed by fire prior to the execution of the contract, what rights has *X* against *Y*?

(b) If, without negligence or fault by either party, said goods were completely destroyed by fire after the execution of the contract but before delivery to *X* and while the goods were at the seller's risk, what rights has *X* against *Y*?

(a) *X* has no rights against *Y*. The Uniform Sales Act provides² that "Where the parties purport to sell specific goods, and the goods without the knowledge of the seller have *wholly perished* at the time when the agreement is made, the agreement is void." Even without the Uniform Sales Act provision, the transaction would be void under the common law as a contract involving mutual mistake as to the existence of subject matter (sec. 132).

(b) Here, too, *X* would have no rights against *Y*. The Uniform Sales Act provides³ that "Where there is a contract to sell specific goods, and subsequently but before the risk passes to the buyer, without any fault on the part of the seller or buyer, the goods wholly perish, the contract is thereby voided."

1510. AI Nov. 1941 (9). In the law with respect to sales of goods, define and illustrate each of the following terms:

(a) Fungible goods.

(b) Future goods.

²Sec. 7, subd. (1).

³Sec. 8, subd. (1).

- (c) Divisible contract to sell, or divisible sale.
- (d) In good faith.
- (e) Specific goods.

(a) See sec. 1499.

(b) See sec. 1499.

(c) A sale or a contract to sell is divisible if it has separate and distinct parts and creates separate and distinct obligations; as, for example, when a vendor sells, under the same contract, a horse, a cow and an automobile, involving different delivery dates and separate prices for each item.

(d) A purchaser in good faith is one who buys without knowledge, suspicion or reason to know or suspect that the vendor's title was defective or the transaction irregular. "Good faith consists in an honest intention to abstain from taking any unconscientious advantage of another, even through the forms or technicalities of law, together with an absence of all information, notice, or belief of facts which would render the transaction unconscientious."⁴

(e) See sec. 1499.

1511. AI-NY May 1945 (2). (a) What are the general provisions of the statute of frauds as to a sale of personal property?

(b) When is a written memorandum necessary to take a sales contract out of the statute of frauds?

(c) What are the essential elements of such a memorandum?

(d) Must the memorandum be in (1) a special form or (2) a single writing?

(e) Aiken sold by sample 1000 bushels of wheat to Bowen and 1000 bushels to Clark, to be delivered at Aiken's warehouse. Bowen paid for his purchase, Clark did not. Aiken measured out the wheat, which conformed to the sample, put it into bags for delivery and awaited Bowen's and Clark's orders. Thereafter the warehouse and its contents, including the wheat in both parcels, were destroyed by fire through no fault of either party. There was no insurance on the property and contents.

Aiken sues Clark for the price of the wheat sold him.

Bowen sues Aiken for the value of the wheat purchased by him.

What are the rights and liabilities of Aiken, Bowen and Clark, respectively? Explain fully.

(a) See sec. 1413.

(b) A written memorandum is necessary to take a sales contract out of the statute of frauds when the buyer has neither received and accepted part or all of the goods sold, nor made payment, in whole or in part, of the purchase price. (See sec. 1413.)

⁴ *Black's L. Dic.* 849.

(c) See sec. 1414.

(d) (1) No particular form of memorandum is prescribed by the statute of frauds. (2) It may consist of a single writing, or several writings, such as an exchange of letters or telegrams.

(e) Aiken is entitled to payment from Clark, and he is not liable for the value of the wheat purchased by Bowen. At the time of the fire, title to the wheat had passed to both purchasers, and since the loss occurred without fault of either party, it must fall on the owners of the wheat. Since Clark did not pay for his wheat, he owes Aiken for it.

In a sale by sample, title passes when goods corresponding to the sample are unconditionally appropriated to the contract, that is, set aside for the buyer or specifically designated or marked in some way as sold to him. (See sec. 411.) The goods in this case were unconditionally appropriated to the contract prior to the fire.

1512. AI-NY Nov. 1945 (7). (a) Define a bill of lading.

(b) What is: (1) a straight bill of lading, (2) an order bill of lading?

(c) What four purposes are served by shipping goods under order bills of lading? Explain.

(d) Anson met Box and said to him, "For what will you sell me 500 barrels of flour?" Box replied, "Ten dollars a barrel, cash on delivery." Anson said, "All right, I accept; deliver the flour to my warehouse tomorrow morning." The next day flour dropped in value and was worth \$8 a barrel when Box tendered the flour to Anson the next morning. Anson refused to accept at the price agreed upon. What can Box do?

(a) See secs. 597 and 1545, subd. (c).

(b) See sec. 603.

(c) See sec. 1546, subd. (c).

(d) Box can do nothing. Under the statute of frauds, an oral agreement for the sale of personal property of the value of \$500 or more is unenforceable in any state (except Ohio⁵), unless it is accompanied by payment, in whole or in part, or by delivery and acceptance of part or all of the merchandise. The Uniform Sales Act allows a maximum of \$500. In many states, the allowable maximum for oral contracts is \$50. (See table on page 91.)

1513. NY Oct. 1943 (8). (a) Compare or contrast the meanings of warranty and guaranty.

⁵ The allowable maximum in Ohio is \$2500.

(b) Compare or contrast the meanings of express and implied as adjectives describing a warranty.

(c) What warranties are implied in the sale of a chattel?

(a) A warranty is a statement made on behalf of one's self in connection with a sale or other transaction. A guaranty is an undertaking to answer for another's obligation, that is, to make good if the other defaults (sec. 903).

(b) Basically, an express warranty is one created by words, oral or written. The Uniform Sales Act defines it as follows: "Any affirmation of fact or any promise by the seller relating to the goods is an express warranty if the natural tendency of such affirmation or promise is to induce the buyer to purchase the goods, and if the buyer purchases the goods relying thereon." An implied warranty is one deducible from conduct or the circumstances. A warranty may also be implied in law from considerations of public policy. (See sec. 416.)

(c) The following warranties are implied in the sale of a chattel: (1) that the owner owns what he sells (warranty of title); (2) when goods are sold by sample, that the bulk shall correspond with the sample in quality, that the buyer shall have a reasonable opportunity of comparing the bulk with the sample, and that if the seller is a dealer in goods of that kind, the goods shall be free from any defect rendering them unmerchantable which would not be apparent on reasonable examination of the sample; (3) in a sale by description, that the goods will correspond to the description; and (4) in a sale for a particular purpose (either made known by the buyer to the seller, or where the purpose should have been known by the seller from the nature and circumstances of the purchase, and where the buyer relies on the seller's skill or judgment), that the goods shall be reasonably fit for such purpose.

1514. NY Apr. 1940 (9). In an effort to secure an order for merchandise, a manufacturer made representations as follows:

(a) He showed a sample of the merchandise in which there was an obvious defect.

(b) He told the prospective purchaser that the material was the best on the market.

(c) He did not tell the prospective customer that the seller was the owner of the merchandise.

As to each of these representations, was there any warranty, express or implied? Give reasons for each answer.

(a) This being a sale by sample, the seller impliedly warranted that the bulk would correspond with the sample in

quality; that the buyer would have a reasonable opportunity of comparing the bulk with the sample; and if the seller was a dealer in goods of the kind sold, that the goods would be free from any defect rendering them unmerchantable which would not be apparent on reasonable examination of the sample. This would exclude the obvious defect referred to; that is, if the bulk contained the obvious defect shown in the sample, the buyer would have to take such merchandise as is.

(b) The representation in question did not amount to a warranty but was more in the nature of an expression of opinion.

(c) The seller did not have to tell the prospective customer that he was the owner of the merchandise; there was an implied warranty to this effect, as there is in connection with all voluntary sales.

1515. NY Apr. 1942 (9). (a) What warranty by the seller is implied in most sales?

(b) What exceptions are there to the general rule?

(c) What additional warranties are implied in (1) a sale by sample, (2) a sale by description, (3) a sale for particular purpose?

(a) A warranty of title by the seller is implied in most sales.

(b) A warranty of title is not implied where goods are sold at forced or judicial sales, such as executors', administrators', auctioneers' or sheriffs' sales.

(c) See secs. 418-420, and sec. 1513, subd. c.

1516. AI May 1941 (4). (a) Define express warranty with respect to a sale, and give a brief statement of facts illustrating one.

(b) Define representation with respect to a sale, and give a brief statement of facts illustrating one.

(a) For a definition of an express warranty, see sec. 1513, subd. (b). An example of an express warranty is furnished by the facts in the case of *V. Valente Inc. v. Mascitti*,⁶ wherein the seller told the buyer of a radio receiving set that the buyer could "get" any station in Rome clearly at any time. The Court held that this was an express warranty, a breach of which precluded the seller's recovery of the unpaid balance of purchase price upon the buyer's offering to return the radio.

(b) A representation is an antecedent statement made to induce a sale or contract of sale; a warranty is part of the contract itself. A breach of warranty constitutes a breach of

⁶ 163 Misc. 287, 295 N.Y. Supp. 330.

the contract. A fraudulent representation constitutes a tort. The important thing about a representation is whether it is true or false. The important thing about a warranty is whether it is performed. (See secs. 130 and 416.)

For example, the owner of a typewriter, to induce a sale, stated that he had personally paid \$85 for it. The bill of sale contained the following clause: "This machine is warranted to be in good working order and to be made up of its original parts. No parts have been supplied in reconditioning same." The first statement, which induced the making of the contract, was a representation; the second, a warranty.

1517. AI Nov. 1937 (4). (a) What is meant by the maxim *caveat emptor*?

(b) State briefly the facts of a transaction to which it would be applied.

The maxim *caveat emptor* means, literally, let the buyer beware. The application of this maxim imposes on the buyer the duty of examining what he buys and the risk that if he fails to observe obvious defects at the time of purchase, he will have no recourse against the seller because of any deficiencies in the quality of the merchandise purchased. Exceptions to the *caveat emptor* doctrine are made in the following cases: (1) where the parties do not deal at "arm's length," as in the case of fiduciary transactions, such as those between principal and agent, attorney and client, trustee and beneficiary, and so on; (2) where defects are latent, not obvious, and the buyer has not had a full opportunity for inspection; (3) sale by sample; (4) sale by description; and (5) sale for particular purpose. (See secs. 418-420.)

For example, if a person, with a full opportunity for inspection, buys a secondhand automobile with a hole in the roof of the car, or a missing front bumper, he cannot later complain of such defects, since they were obvious upon inspection.

1518. AI May 1942 (6). A certified public accountant in his own office explained to a sales agent representing a manufacturer of calculating machines the kind of work for which the accountant required a machine and stated to the agent that he was relying on the agent's skill and judgment in recommending a machine for that purpose. The agent thereupon sold a machine for cash to the accountant and gave him a bill of sale which contained no warranty but merely described the machine by style, lot number, and price. If the accountant then discovered that the machine could not do the required work, was there any legal ground upon which the accountant could return the machine and obtain a refund of the purchase price?

The accountant may return the machine and obtain a refund of the purchase price. He had a right to rely on an implied warranty of fitness for the particular purpose intended. The calculating machine was sold for a particular purpose. The seller was apprised of such purpose. The buyer relied on the agent's skill and judgment, and the agent knew it. The circumstances furnish an illustration of a sale for a particular purpose, which is an exception to the *caveat emptor* doctrine. (See sec. 420.)

1519. NY Oct. 1936 (6). Mention *four* remedies that are available to an unpaid seller after title has passed to the buyer.

Six remedies available to an unpaid seller after title has passed to the buyer are: (1) lien, (2) stoppage in transit, (3) resale, (4) rescission, (5) action for price, (6) action for damages. (For an explanation of these remedies, see secs. 422-428, inclusive.)

1520. NY Apr. 1939 (4). (a) What is stoppage in transitu?

(b) What *three* conditions must be present before the right of stoppage can be exercised?

(c) Can the right of stoppage in transitu be exercised if goods are shipped on an order bill of lading?

(d) Explain.

(a) The right of stoppage in "transitu," or transit, is the right which an unpaid seller has, under certain conditions, to stop the goods during shipment. Although the unpaid seller loses his vendor's lien when he parts with possession, and although delivery to a common carrier is delivery to the buyer's agent, hence a parting with possession by the seller, nevertheless the law gives the seller a right, in the nature of an equitable lien, to reassert and reclaim possession, provided three conditions are present.

(b) The three conditions which must be present before the right of stoppage in transitu can be exercised are:

(1) The buyer of the goods is or becomes insolvent.

(2) The goods are still in transit, that is, have not been actually delivered by the carrier to the buyer or his agent.

(3) The goods are sold on credit.

(c) The right of stoppage in transitu cannot be exercised if goods are shipped on an order (that is, negotiable) bill of lading. "Where a negotiable bill has been issued for goods, no seller's lien or right of stoppage in transitu shall defeat the

rights of any purchaser for value in good faith to whom such bill has been negotiated, whether such negotiation be prior or subsequent to the notification to the carrier who issued such bill of the seller's claim to a lien or right of stoppage in transitu. Nor shall the carrier be obliged to deliver or justified in delivering the goods to an unpaid seller unless such bill is first surrendered for cancellation."⁷ The act of a carrier in delivering up goods so shipped, except upon surrender of the bill of lading, is punishable by imprisonment not exceeding one year, or by a fine not exceeding one thousand dollars, or both.⁸

(d) When goods are shipped on an order bill of lading, they are deliverable to the order of the person to whom the bill of lading has been issued. The very essence of such a bill of lading is negotiability, at least to the extent of rendering the merchandise readily transferable to the order of the person named in such document of title. The form and purposes of the instrument are designed with a view to protecting innocent transferees. To permit a shipper to exercise the right of stoppage in transitu after an order bill of lading has been issued would defeat the very purpose of such a document. "The voluntary act of the owner of property in giving to another a bill of lading which unqualifiedly directs the common carrier to whom the goods therein described have been committed for transportation to deliver such goods to the person named in the bill of lading or to his order is deemed a sufficient act to estop him from making any claim upon the goods as against a person dealing in good faith with the person named therein."⁹

1521. NY Oct. 1935 (2). When shipping goods to a purchaser, how may the seller retain title in himself until the purchase price is paid? How is title passed when the purchaser makes payment?

The seller may retain title in himself until the purchase price is paid by draft drawn on the buyer for the price, transmitted with the bill of lading to a bank or other agent for collection. Title passes in such case when the purchaser makes payment or accepts the draft upon delivery of the bill of lading. (See sec. 429.)

1522. AI May 1944 (8). In sales, what is meant by:

(a) Sales in bulk?

⁷ Uniform Bills of Lading Act, sec. 42.

⁸ *Penal Law* (N.Y.), sec. 365.

⁹ *Gass v. Astoria Veneer Mills*, 134 App. Div. 184, 118 N.Y. Supp. 982, 986.

- (b) What is the purpose of the Bulk Sales Act?
- (c) Passing of title?
- (d) Under what circumstances may a seller of merchandise exercise stoppage in transitu?
- (e) On what principle is the right given to an unpaid seller for stoppage in transitu?

(a) The term "sales in bulk" relates to a sale of all or a substantial part of a merchant's stock of goods, as distinguished from sales in the ordinary course of the merchant's business. A sale in bulk is made where separating, counting, measuring, weighing or dividing in parcels, packages or barrels does not take place but where the mass is sold as one.¹⁰

(b) The purpose of the Bulk Sales Act is to prevent dishonest merchants from buying up large quantities of merchandise on credit, reselling it to third parties, and defrauding creditors by failing to pay for such merchandise. (See sec. 431.)

(c) To "pass title" is to transfer ownership.

(d) A seller of merchandise may exercise the right of stoppage in transitu under the following conditions: (1) The goods are sold on credit; (2) the buyer is or becomes insolvent; (3) the goods are still in transit. (See sec. 423.)

(e) The basis of the right of stoppage in transitu is equity, which projects an equitable lien over goods no longer in the seller's possession, to prevent an insolvent buyer from getting something for nothing at the seller's expense, thereby protecting the seller, without prejudice to any substantial right on the part of the buyer.

1523. AI May 1937 (6). Defendant, an importer of coffee, contracted to sell to plaintiff all of its discarded imported bags, defendant's usual practice having been to discard these bags after the coffee had been repacked in its own containers. During the existence of this contract, defendant decided to retain the imported bags and without plaintiff's knowledge or consent defendant purchased similar bags from a competitor of plaintiff's and then delivered them to plaintiff at the contract price, which resulted in a profit to defendant. Is this legally a compliance with the contract of sale?

The acts stated did not constitute legal compliance with the contract. Failure to deliver a particular chattel ordered is equivalent to a failure to deliver. A buyer is entitled to get what he buys; he need not accept a substitute. (See sec. 434.)

¹⁰ *Conquest v. Atkins*, 123 Me. 327, 122 A. 858; *Feldstein v. Fusco*, 205 App. Div. 806.

1524. AI May 1938 (7). (a) Define and describe conditional sales.

(b) How can the seller usually protect himself in such sales?

(c) Upon default by the buyer in a conditional sale, what are the seller's usual rights as to retaking possession of the goods sold?

(d) After such a seller has lawfully retaken possession, what are the buyer's usual rights as to redemption?

(a) A conditional sale is a contract for the sale of goods under which the seller parts with possession but retains title as security pending full payment of the price. Conditional sales include, also, any contract for the bailing or leasing of goods by which the bailee or lessee contracts to pay as compensation a sum substantially equivalent to the value of the goods, and by which it is agreed that the bailee or lessee is bound to become, or has the option of becoming the owner of such goods upon full compliance with the terms of the contract.

(b) The seller's protection against the buyer's nonpayment, in addition to the usual legal redress for nonpayment, consists in reserving his title until all payments are made so that, in case of default, he may retake possession and pursue the other remedies of a conditional vendor (secs. 446-449). The seller's protection against the risk of resale by the conditional vendee to an innocent third party for value lies in the legal device whereby, upon the required public filing of the conditional sales contract or a true copy thereof, the world is constructively given notice that the conditional vendor is still the owner of the goods, so that, until the goods are paid for, there can be no innocent third party capable of acquiring title as against the conditional vendor (sec. 442).

(c) Upon default by the buyer in a conditional sale, the seller may retake possession of the goods; peacefully if possible, otherwise by legal process.

(d) There is considerable diversity of statutory provision on the buyer's rights of redemption. In states which have adopted the Uniform Sales Act the buyer has a right to redeem unless (1) the seller, before retaking, gave the buyer advance notice of his intention to retake, (2) gave him an opportunity to make good the default before the retaking, and (3) the buyer failed to make good notwithstanding. If the buyer did not receive such notice, he has ten days after the retaking within which to redeem the goods by making good the default plus expenses of retaking.

1525. NY Apr. 1941 (14). A manufacturer delivers identical merchandise to

A upon a conditional sale

B upon a lease with option to purchase

C upon a consignment

Discuss each transaction with special reference to the rights of the manufacturer and the records he should make.

Delivery to A upon conditional sale. The manufacturer retains title to the merchandise. He should promptly file the original or a transcript of the conditional sales agreement in the place of public record provided for such purpose. He has a right to receive the payments stipulated under the contract and upon default in any of the payments, to retake the merchandise subject to the buyer's right to redeem under certain conditions (sec. 447). If he retakes the merchandise, he is compelled to resell it upon notice under certain conditions; under other conditions, not (see sec. 448). If on the resale there is a surplus over the balance due plus expenses, the manufacturer must pay over such surplus to the buyer. If there is a deficiency, he may recover it from the buyer (sec. 449). If there is no resale and none was required, the seller may retain the goods as his own property without obligation to account to the buyer; if a resale was required under the law but not held, the buyer may recover his actual damages from the seller, in no event less than one fourth of the sum of all his payments, with interest. The records which the manufacturer should make are those which will reflect the foregoing rights and obligations, including dates when payments are due, amount of each installment, payments received, time for filing, and for refile sales agreement, and so on.

Delivery to B upon lease with option to purchase. If the lease with option to purchase requires the lessee to pay as compensation a sum substantially equivalent to the value of the goods, it is indistinguishable from a conditional sale, and the manufacturer's rights and records will correspond to those referred to in the preceding paragraph. If the buyer is not obligated to pay as compensation a sum substantially equivalent to the value of the goods, the transaction will be treated as a lease of personal property, with rental payments at intervals set forth in the contract. Until the lessee has exercised his option of becoming the owner of such goods and has complied with the terms for acquiring such ownership, the ownership

will be reflected in the manufacturer's records among his assets, and the rental payments will be shown as income instead of installment payments on the purchase price.

Delivery to C upon consignment. The manufacturer retains title to the merchandise unless and until *C* sells the goods to a third party. In the interim the manufacturer's records will show retention of title in the merchandise by the manufacturer (see sec. 396).

1526. NY Apr. 1935 (8). How does a conditional sale differ from a lease with an option to purchase? How may a conditional vendor protect his rights?

(1) In a conditional sale the seller retains title until the purchase price is paid, but such title will not avail as against an innocent purchaser for value who acquires the goods from the conditional purchaser, unless the conditional seller has filed the conditional sales contract or a copy of it as required by law. In a lease with an option to purchase, if the buyer is required under the contract to pay compensation substantially equivalent to the value of the goods, there is no difference between such transaction and a conditional sale. If he is not required to make payment of such sum, but has the option of doing so and of acquiring title upon making a given number of payments, he is a lessee, and the owner of the merchandise—whether he publicly files the agreement or not—is protected in his ownership against possible purchasers for value without notice from the lessee, because a lessee is a mere bailee, and a bailee, from the mere fact of possession, does not have ostensible authority to pass title to third parties, regardless of the good faith or value given by such third parties.

(2) In a conditional sale, the seller, upon the buyer's default, can retake the chattel only by strictly observing the statute governing conditional sales. The buyer has a right to redeem the chattel within a prescribed period, and if the chattel is not redeemed, and the buyer has paid in at least 50% of the purchase price, the seller must resell the chattel at public sale, upon due notice to the buyer. None of these restrictions apply to a lessee with an option to purchase, unless the lease is equivalent to a conditional bill of sale in line with the test specified in the preceding paragraph. If the transaction is a mere lease, and not a conditional bill of sale, the lessor's right to retake is absolute.

CHAPTER V-A

Bailments and Carriers

1527. AI Nov. 1943 (10). (a) What is a bailment?
(b) How do bailments differ from sales and gifts of chattels?
(c) What is a warehouseman, and what is his liability?

(a) A bailment is the delivery and acceptance of personal property for some particular purpose, upon condition that the property be redelivered when it has served its purpose, or that it be kept until reclaimed, or that it be otherwise dealt with according to agreement.

(b) A bailment transfers possession alone; a sale transfers title, with or without possession.

Bailments and gifts both require transfer of possession. In the case of a bailment, however, title remains in the transferor; in the case of a gift, title passes to the transferee.

(c) A warehouseman is a bailee engaged in the business of storing goods for profit. Like all bailees, a warehouseman must redeliver the identical merchandise stored, except that the proprietor of a grain elevator, being engaged in the storage of fungible goods (sec. 410, subd. (e)) is required merely to return grain of equivalent quantity and quality. Warehousemen are not liable for loss, damage or destruction of goods stored, unless caused intentionally or negligently by the warehouseman, his agents, servants or employees. A warehouseman is a bailee for profit; he is therefore required to exercise ordinary care and is liable for ordinary negligence.

1528. NY Oct. 1936 (5). What *three* elements must be present in order to give rise to a bailment?

Three elements which must be present in order to give rise to a bailment are: (1) a valid existing chattel, (2) transfer of possession, and (3) acceptance. (See sec. 454.)

1529. AI Nov. 1942 (3). (a) State which if any of the following transactions is a bailment:

- (1) *X* delivers goods to the *Y* railroad for shipment as freight.
- (2) *X* delivers goods to *Y* on consignment to be sold by *Y*.

(3) *X* delivers goods to *Y*, his servant, with instructions to *Y* to place them in storage in the name of *X* three months thereafter.

(b) State the duties of a bailee with respect to his care of the property bailed in each of the following types of bailment:

(1) A gratuitous bailment for the bailor's sole benefit.

(2) A gratuitous bailment for the bailee's sole benefit.

(3) A bailment for hire for the mutual benefit of both bailor and bailee.

(a) Transactions (1) and (2) are bailments, since they conform in every respect to the definition of a bailment (sec. 453), though transaction (2) differs in several respects from an ordinary bailment (sec. 455). Transaction (3) is not a bailment, since giving custody to an employee does not constitute a transfer of possession; the employee's possession is the employer's possession.

(b) (1) In a bailment for the sole benefit of the bailor, the bailee, who is merely accommodating the bailor, is required to exercise but slight care, hence is liable only for gross negligence.

(2) In a bailment for the sole benefit of the bailee, the latter is being accommodated, hence he must exercise great care and is liable for slight negligence.

(3) In a bailment for mutual benefit, neither party is being accommodated. The bailee must exercise ordinary care and is liable for ordinary negligence.

1530. NY Oct. 1942 (6). (a) Is a transfer of possession and/or of title necessary in (1) a bailment, (2) a sale, (3) a gift?

(b) In the law of bailments, what is meant by conversion?

(a) (1) Transfer of possession is necessary. Transfer of title is neither necessary nor consistent with a bailment.

(2) Transfer of possession is not necessary for the consummation of a sale; only transfer of title is required.

(3) Transfer of both title and possession is necessary in a gift.

(b) Conversion is the unlawful exercise of possession by one person of a chattel belonging to another. Where a bailee's possession becomes unlawful, as where he wrongfully refuses to restore possession to the owner, or where he uses the chattel in a manner contrary to the purpose of the bailment, he is guilty of conversion.

1531. NY Apr. 1938 (10). (a) Has either party or have both parties an insurable interest in a bailment? Explain.

(b) What is meant by a bailee's lien? How may it arise?

(a) Both bailor and bailee have an insurable interest in the

bailment. The bailor has an insurable interest because he is the owner; the bailee, because he stands to benefit from the preservation or continuance of the bailment, and to suffer loss or detriment from its loss, damage or destruction.

(b) A bailee's lien is his right to retain possession of the bailment until some charge or obligation in connection with it is discharged or satisfied. The lien is possessory; that is, it arises out of and depends upon possession. It may arise out of (1) services in connection with the bailment, such as custody (warehouseman's lien), transportation (carrier's lien) or labor and skill bestowed on the chattel (artisan's lien), or (2) special contract whereby a bailment is created for purposes of security (pledge) in connection with some collateral obligation.

1532. NY Oct. 1938 (12). Miss Allen left her watch at a shop for repair on Tuesday night. The same night the shop was destroyed by fire.

(a) Was the owner of the shop responsible for the value of the watch?

(b) Explain.

(a) The owner of the shop was not responsible for the value of the watch unless he was negligent.

(b) A bailee is not liable for the loss or destruction of a bailment, unless some degree of negligence can be imputed to him in connection with such loss or destruction. The degree of care which a bailee must exercise, and the consequent degree of negligence for which he is liable, depend on the nature of the bailment. In a bailment for the sole benefit of the bailor, the bailee need exercise only slight care, and hence is not liable except for gross negligence. If the bailment is for the sole benefit of the bailee, he must exercise great care, and hence is liable even for slight negligence. In a bailment for mutual benefit, the bailee need exercise only ordinary care, and hence is liable for ordinary negligence. What constitutes gross, slight or ordinary negligence, depends upon the facts of each case.

The shop owner, in the above case, was a bailee for the hire of service (repairs on a watch). Hence the bailment was one for mutual benefit. The shop owner was therefore liable for ordinary negligence. Was he guilty of such negligence in causing, or failing to prevent the fire? If he was, he is liable. If not, he would not be liable, unless it was negligence to omit insuring his stock of bailments. Assuming that it is not customary to do this, the shop owner would not be liable.

1533. NY Oct. 1941 (1). (a) State the extent of the care a bailee should give to similar property received from three persons as follows:

X deposits the property solely for his own convenience.

Y deposits the property for their common advantage.

Z deposits the property solely for the bailee's advantage.

(b) Must a bank retain for return to a borrower the identical securities it receives as collateral?

(a) When *X* deposits the property solely for his own convenience, the bailee derives no benefit, is required to exercise slight care, and is liable for gross negligence.

When *Y* deposits the property for the mutual benefit of the bailee and himself, the bailee must exercise ordinary care, and is liable for ordinary negligence.

When *Z* deposits the property solely for the bailee's benefit, the bailee must exercise great care, and is therefore liable for slight negligence.

What constitutes gross, ordinary and slight negligence depends upon the facts in each case.

(b) A bank need not retain for return to a borrower the identical securities it receives as collateral, so long as it has on hand, at all times, an equivalent quantity of the securities pledged to answer the borrower's redemption. Securities, unlike other chattels, are evidences of rights, rather than things in themselves. One certificate for a given number of shares of stock is no different from another certificate for the same number of shares of the same stock.

1534. AI May 1935 (12). (a) In an ordinary bailment, what are the duties of a bailee for hire with respect to the custody and care of the bailor's property?

(b) Does a bank which holds corporate stocks pledged on a collateral loan have the same duties as a bailee for hire? If not, what are the differences?

(c) List the most important provisions of a bill of lading which is negotiable.

(a) In an ordinary bailment the bailee is required to exercise ordinary care, that is, he is liable for ordinary negligence. What constitutes ordinary care or ordinary negligence depends upon the facts of each case.

(b) A bank which holds corporate stocks pledged on a collateral loan does not have the same duties as a bailee for hire. The ordinary bailee for hire must return the identical chattel. The bank as pledgee need not return the identical stock certificate or certificates deposited by the pledgor, but is merely re-

quired, upon satisfaction of the pledge, to return a certificate or certificates for an equal number of the shares which were pledged.

(c) A negotiable bill of lading must have the words "order of" printed immediately before the name of the person upon whose order the goods are deliverable. In addition, every bill of lading must embody within its written or printed terms at least the following: (a) date of issue, (b) name of person from whom goods have been received, (c) place where goods have been received, (d) place to which goods are to be transported, (e) statement whether goods received will be delivered to a specified person or to the order of a specified person, (f) description of goods or of packages containing them, and (g) signature of carrier.

1535. AI Nov. 1940 (5). *X* borrowed *Y*'s automobile without paying any consideration therefor for the avowed purpose of driving it from St. Louis to Memphis and return in order to make an audit in Memphis. Without *Y*'s knowledge or consent, *X* drove this car to Kansas City and return, and on the return trip, the car was damaged, without negligence by *X*, as a result of a highway defect. This trip to Kansas City was occasioned by an unexpected request that *X* make an audit there. *Y* was not employed by or in any way associated with *X* and *Y* had no interest in or connection with either of these audits.

(a) What kind of bailment is this?

(b) Can *Y* hold *X* financially responsible for the damage to the car?

(a) This is a gratuitous bailment: for the sole benefit of the bailee.

(b) *Y* can hold *X* financially responsible for the damage. If a bailee uses a bailment for a different purpose than that agreed upon, he is liable to the bailor—regardless of negligence—for any loss, damage or destruction during the course of such use.

1536. NY Oct. 1939 (15). (a) Name *three* essentials of a pledge.

(b) Can creditors of a pledgor or of a pledgee secure any rights in pledged property?

(c) If the proceeds of a sale of pledged property are not sufficient to pay the obligation in full, is there any further liability on the part of the pledgor?

(a) Three essentials of a pledge are (1) a debt or obligation, (2) a pledgor and a pledgee, and (3) the transfer of the pledged property from the pledgor to the pledgee. Other essentials sometimes mentioned are (4) a contract, express or implied, governing the pledge, (5) a lien on the property pledged, (6)

legal title reserved to the pledgor, and (7) a right of redemption in the pledgor.

(b) *A pledgor's creditor* may proceed against the property pledged, to the extent of the pledgor's interest; that is, to the extent of his right of redemption. Such creditor may pay the debt secured by the pledge and then levy upon the property. *A pledgee's creditor* may proceed against the pledged property only to the extent of the pledgee's possible interest in case of the pledgor's default; that is, his remedy is limited to the pledgee's remedy of selling the chattel upon the pledgor's default subject to the terms of the pledge.

(c) If the proceeds of a sale of pledged property are not sufficient to pay the obligation in full, the pledgor may be compelled to make good the deficiency.

1537. NY Apr. 1935 (1). What is a pledge? Wherein does it differ from a chattel mortgage? What do you understand by the term *collateral security*?

A pledge is the bailment of personal property as security for the discharge of an obligation.

A pledge differs from a chattel mortgage in three respects: (1) nature of the security, (2) necessity of public notice (by filing), and (3) rights on default. (See sec. 472.)

The word "collateral" literally means "by the side of," or "on the side"; that is, something on the side of, or in addition to, a direct obligation, given to secure such obligation. Collateral security is therefore some form of security which accompanies and secures an obligation. The term *collateral security* is defined in Black's Law Dictionary as follows: "A security given in addition to the direct security, and subordinate to it, intended to guaranty its validity or convertibility or insure its performance; so that, if the direct security fails, the creditor may fall back upon the collateral security." The following definition is given by the court:¹ "Collateral security has been held to be a concurrent security for another debt, whether antecedent or newly created, and is designed to increase the means of the creditor to realize the principal which it is given to secure. It is subsidiary to the principal debt; *running parallel with it, collateral to it; and, when collected, is to go to the credit of the principal debt.*"

¹ *In re Alexander's Estate*, 152 Misc. 354, 273 N.Y. Supp. 984, 988.

By common usage, the term *collateral security* has come to mean stocks and bonds deposited to secure a debt.

1538. NY Oct. 1938 (15). (a) Define pledge and give an example.

(b) Is transfer of possession essential to a pledge?

(c) May the pledgee assign or repledge his interest in the pledged article?

(a) For a definition of pledge, see preceding section. The most common example of a pledge is a pawn, as where one pawns his watch with a pawnbroker.

(b) The transfer of possession, actual or constructive, is essential to a pledge.

(c) "In the absence of an agreement to the contrary, the pledgee may sell the principal debt and transfer the collateral to the purchaser, if nothing is done to deprive the pledgor of the right to redeem on payment of the amount due on the principal debt."²

1539. NY Oct. 1939 (6). (a) What is collateral security?

(b) To whom does income thereon belong?

(c) What are the legal terms designating the parties to a transaction concerning collateral security?

(a) See sec. 1537.

(b) Income on collateral security belongs to the pledgor, but the pledgee or person with whom the security is deposited may collect such income and apply it in reduction of the debt secured. "Plaintiff, as the pledgee of one Skolkin, the owner of stock . . . sues to recover from the defendant dividends declared on such stock. . . . The pledgee has the right to retain possession and control of the pledge with the income and benefits in addition thereto, until the debt is paid, and it is the pledgee's duty to collect dividends on the stock and apply them to the reduction of the indebtedness. *Brightson v. Claffin*, 225 N.Y. 469, 122 N.E. 458."³

(c) The parties to a deposit of collateral security are the *pledgor*, or owner of the security, who deposits it with the *pledgee*, to whom the debt thus secured is due.

1540. NY Oct. 1937 (12). (a) How is a pledge of stock usually made?

(b) Has the pledgee the right to sell or to repledge the stock?

(c) Must the pledgee return to the pledgor the identical certificate representing the stock pledged?

² 49 *Corpus Juris* 963.

³ *Manufacturers Trust Co. v. Bank of Yorktown*, 156 Misc. 793, 282 N.Y. Supp. 507.

(a) A pledge of stock is usually made by depositing the stock certificate with the pledgee, duly indorsed in blank by the pledgor. Such indorsement consists of the pledgor's signature to an assignment, which usually carries with it a power of attorney delegating authority to transfer the stock on the books of the corporation. The assignment and power of attorney may be either printed, typewritten or handwritten on the back of the certificate itself, or it may consist of a "fly-power." "A fly-power is a written assignment in the form generally used on the reverse of stock certificates, which, when signed and attached to such certificate, is sufficient to transfer the same in like manner as an indorsement thereon."⁴ The reason why a pledge is usually made in this manner, that is, by the execution of an assignment in blank coupled with a power of attorney to transfer the stock, is that as a rule the terms of the pledge are such as to authorize the pledgee to sell the property pledged "at public or private sale, with or without notice to the pledgor," in case of default by the pledgee. In order that certificates of stock may be readily disposed of in accordance with such terms usually embodied in a pledge, it is necessary that they be indorsed in blank in advance, with power of attorney, upon the pledgor's default, to transfer the stock without further notice to the pledgor.

(b) This question is answered by the Court as follows:⁵ "The legal rules which govern the respective rights of the parties in this transaction have been the subject of repeated adjudication, and the law bearing thereon is fairly well settled. The relation which is established between the broker and a customer who buys stocks upon margin is that of pledgor and pledgee. The legal title to the stocks is in the purchaser, and the brokers are the pledgees of the same for the repayment of all advances made by them in connection with the transaction. *Markham v. Jaudon*, 41 N.Y. 235; *Baker v. Drake*, 66 N.Y. 518, 23 Am. Rep. 80; *Gillett v. Whiting*, 120 N.Y. 402, 24 N.E. 790. Under such relation the broker has the right to pledge the stocks and obtain from the pledgee advances of money thereon, and the latter, by such transaction, obtains a good lien thereon which he may enforce by a sale of the pledge without

⁴ *Carlisle v. Norris*, 157 App. Div. 313.

⁵ *Rothschild v. Allen*, 90 App. Div. 233, 86 N.Y. Supp. 42, 43-44, aff'd 180 N.Y. 561.

notice to the owner of the legal title, and without incurring any liability to him therefor, or to the broker making the pledge. The duty and obligation which the broker owes to his customer, however, is quite different. It was said by this court, in speaking of such obligation:

“The plaintiffs might take title to the securities in their own name, and were not bound to retain or deliver the identical securities purchased for the defendant. Their duty was to keep on hand, or under their control, either the securities of the defendant or a like kind and amount of securities, and to have them in such situation that the defendant, by paying the amount due by him thereon, could at any time obtain them. This was what the plaintiffs agreed to do, and, so long as they did this, the fact that they used the securities while in their possession, awaiting redemption by the defendant, would not amount to a conversion thereof.” (*Douglas v. Carpenter*, 17 App. Div. 329, 45 N.Y. Supp. 219.)”

(c) The pledgee need not return to the pledgor the identical certificate representing the stock pledged. “When they accounted for the number of shares pledged with them they discharged their obligations, even though they did not return the identical certificates which had been pledged.”⁶ “The stock purchased for the plaintiff had no earmark, and one share being of equal value with every other share of the same stock, the defendants were not bound to deliver, or to have on hand for delivery any particular shares, or the identical shares purchased for the plaintiff.”⁷

1541. AI-NY May 1945 (6). (a) What *three* elements must be present in order to give rise to bailment?

(b) A warehouseman issued a uniform warehouse receipt, stating that the goods were to be delivered to John Jones or order or bearer, but added a provision that the receipt was nonnegotiable. Why? Was the receipt negotiable or nonnegotiable?

(c) Smith, a customer of a bank, left with the bank for safekeeping three negotiable bonds, the bank agreeing that it would keep them in its vault without charge. The bonds were placed in the vault, duly locked, but were later stolen by bank robbery. Smith sued the bank. Is the bank liable? Give reasons for your answer.

(d) Andrews stored goods in Burt's warehouse at the agreed price of \$100 a month for storage charges. The goods were seized by a sheriff under an order by a court as the result of a judgment against Andrews. Burt im-

⁶ *Carlisle v. Norris*, 215 N.Y. 400, 405.

⁷ *Stewart v. Drake*, 46 N.Y. 449, 453.

mediately gave Andrews notice of the seizure, whereupon Andrews entered suit against Burt. Is Burt liable? Give reasons.

(a) See sec. 1528.

(b) The receipt was negotiable. "A receipt in which it is stated that the goods received will be delivered to the bearer or to the order of any person named in such receipt is a negotiable receipt. No provision shall be inserted in a negotiable receipt that it is nonnegotiable. Such provision, if inserted, shall be void."⁸

(c) The liability of the bank would depend upon whether, under the circumstances, the bank exercised the degree of care required of it. The fact that the bank agreed to keep the bonds in its vault without charge would make the bank a gratuitous bailee, liable only for gross negligence. If the bank agreed to keep the bonds gratuitously for the purpose of retaining the good will of its customer, it would be charged with the duty of exercising ordinary care and diligence, that is, such care and diligence as a reasonably prudent person or corporation would exercise under like circumstances in safeguarding the contents of the vault. It would have to take such measures to safeguard the bonds as are customarily used in the community by ordinarily careful institutions, fairly comparable with itself in size and other conditions. If the bank failed to exercise such care and diligence in failing to prevent the bank robbery, it would then be liable for the loss. In one case⁹ the Court held that a bank was not liable for the loss of the contents of a safe deposit box by burglary when the box was in a vault having a steel door similar to those in use by similar banks and generally recognized as reasonably safe; the vault having been opened by the use of high explosives, and the box itself having been broken open by the use of a sledge hammer and chisel. In another case¹⁰ a country bank conformed to the practice of all other such banks in the state in towns of like population and character. It maintained a safe deposit vault in a building as good as or better than an ordinary bank building with the usual interior arrangements for protection of the vault by doors similar to those of similar banks in similarly sized communities. The Court held that the bank was not

⁸ Uniform Warehouse Receipts Act, sec. 5.

⁹ *Morgan v. Citizens' Bank of Spring Hope*, 190 N.C. 209, 129 S.E. 585.

¹⁰ *Webber v. Bank of Tracy*, 66 Cal. App. 29, 225 P. 41.

liable for loss of the contents of safe deposit boxes by burglary, although it had neither a night watchman nor a burglar alarm (which no such bank had up to the time of the burglary).

(d) Burt's liability depends upon whether he issued a negotiable or a nonnegotiable receipt for the goods. If he issued a negotiable receipt he was liable, otherwise not. The Uniform Warehouse Receipts Act¹¹ provides that if a negotiable receipt is issued for goods delivered to a warehouseman, the goods "can not thereafter, while in the possession of the warehouseman, be attached by garnishment or otherwise, or be levied upon under an execution, unless the receipt be first surrendered to the warehouseman, or its negotiation enjoined. The warehouseman shall in no case be compelled to deliver up the actual possession of the goods until the receipt is surrendered to him or impounded by the court."

1542. AI-NY Nov. 1945 (2). (a) Adams delivered goods to a warehouseman and received a negotiable warehouse receipt for the goods. Yates recovered a judgment against Adams and sought to levy on Adams' goods in possession of the warehouseman. Can Yates levy on or seize the goods? Can the warehouseman be compelled to deliver the goods to Yates? Explain.

(b) Bowen had two trucks, No. 1 and No. 2, which he delivered to repairman Young to make certain repairs. Young, after making repairs to truck No. 1, delivered it to the owner, Bowen, without payment for the repairs. Young then refused to return the other truck, No. 2, until the repairs to truck No. 1 were paid for. Give your explanation of the position of both Bowen and Young in this circumstance at common law.

(c) Farmer Andrews delivered to Bates one thousand bushels of apples; Bates agreed to "return to Andrews one gallon of cider for each bushel of apples." Was this a bailment or a sale and why?

(a) Yates cannot levy on or seize the goods, neither can the warehouseman be compelled to deliver the goods to Yates, unless the receipt is first surrendered to the warehouseman, impounded by the court, or its negotiation enjoined. See sec. 1541, subd. (d).

(b) Bowen may compel Young to return the other truck, No. 2, upon paying the repairs due on that truck. He cannot be compelled, as a condition for the return of such truck, to pay for the repairs on truck No. 1. That is, although Young may collect from Bowen the moneys due for repairing truck No. 1, he has no lien for the payment of such debt, since he surren-

¹¹ Sec. 25.

dered possession of truck No. 1, and his services in repairing truck No. 2 will create a possessory (artisan's) lien only in truck No. 2, which has not yet been surrendered.

This problem illustrates the distinction between a general lien and a particular lien. (See secs. 1134-1135.) Young had a particular lien in truck No. 1 for the work done on that truck, which he lost when he surrendered possession (sec. 1137); and he had a particular lien in truck No. 2 which was still in his possession. A general lien will not be recognized unless the parties have clearly indicated an intention to create one (sec. 1134).

(c) The transaction was a sale, not a bailment. The agreement did not require that the cider be made from the particular apples supplied. (See secs. 395 and 455.)

1543. NY Apr. 1935 (12). What are common carriers? Name *five* different types of companies that are classified as common carriers. To what extent are common carriers liable as insurers?

A common carrier is one who undertakes for hire to transport persons and goods for anyone who may choose to employ him.

Seven types of companies that are classified as common carriers are: (1) railway, (2) express, (3) steamship, (4) public ferry, (5) stage coach, (6) omnibus, and (7) public trucking.

Common carriers are insurers of goods in transit; that is, they are liable for loss, damage or destruction of merchandise entrusted to them for transportation, whether such loss, damage or destruction results from negligence or not. Common carriers are not, however, insurers as to passengers; that is, they are not liable for injury to passengers unless it is occasioned by the carrier's negligence. A common carrier is not liable as an insurer with respect to merchandise no longer in transit which the consignee leaves with the carrier for an unreasonable length of time after being notified of the arrival of the goods; for in such cases, the carrier is liable only as an ordinary bailee, that is, only in case of negligence. Moreover, a common carrier of goods is excused from liability as insurer if loss, damage or destruction is due to one of the following causes:

(1) *Acts of God*, such as floods, snowstorms, hurricanes, cyclones, lightning or fires caused by lightning, and any other extraordinary natural causes beyond the carrier's control.

(2) *Acts of a public enemy*, during a period of organized warfare.

(3) *Fault of the shipper*, such as improper packing, misdirection of merchandise, failure to indicate delicate or fragile contents, and so on.

(4) *Acts of public authorities*, as in the case of seizure by law enforcement or health officers, or of due process, as by attachment, stoppage in transit, and so on.

(5) *Inherent nature of goods*, including perishables, live-stock, and merchandise subject to natural deterioration.

1544. NY Oct. 1937 (7). (a) What is the inclusive descriptive designation for steamboat lines, electric and steam railroads, and so on?

(b) How are they described when wholly within New York State, and how when partly without the state?

(c) To what governmental body do corporations of *each* class report?

(d) State generally for what purposes the reports are required.

(a) The inclusive designation is "common carriers."

(b) When wholly within New York State, they are described as "intrastate" carriers; when partly without the state, that is, in more than one state, "interstate."

(c) Intrastate carriers in New York report to the Public Service Commission, except those operating wholly or partly within the City of New York, which report to the Transit Commission. Interstate carriers report to the Interstate Commerce Commission.

(d) Generally, common carriers are required to make annual reports to the duly constituted regulatory bodies, on forms officially prescribed, so as to insure properly informed government regulation in the public interest with a view to maximum service at minimum cost compatible with a fair rate of return on the investment. Specifically, and to implement these objectives, the information to be furnished in the reports is designed to achieve the following aims:

(1) Standardization and regulation of accounting practices.

(2) Standard minimum rates, free from discrimination.

(3) Control over capitalization and financing.

(4) Maintenance of safe and adequate facilities, including terminals and docks, rolling stock, equipment and appliances.

(5) Maintenance of safe and adequate management, and a personnel sufficient in number and training to operate the service up to the required standards.

1545. AI Nov. 1942 (11). (a) Name five types or kinds of public service corporations which are common carriers.

(b) State the name of the Federal Government agency which prescribes the uniform system of accounts which carriers are required to use, and explain how you would inform yourself about the details of such system of accounts.

(c) Define and describe briefly a bill of lading, stating whether it is a receipt or a contract (or both) and in what circumstances a bill of lading is negotiable.

(d) What is the carrier's legal responsibility in the transportation of (1) freight, and (2) passengers?

(a) Public service corporations which are common carriers include: steamboat lines, electric and steam railroads, trolley and bus lines, express companies, pipe lines, sleeping car companies, telephone and telegraph companies, and air transport lines.

(b) The name of the Federal agency which prescribes the uniform system of accounts for interstate carriers is the Interstate Commerce Commission. The details of such a system of accounts are set forth in published form, with explanations provided by the commission through its main office in Washington and through the various branches or local offices of its Bureau of Accounts. Published rulings of the commission are likewise available to those who wish to inform themselves on various aspects of the uniform system of accounts prescribed for carriers.

(c) A bill of lading is an instrument in writing signed by the carrier or his agent, describing the freight so as to identify it, stating the name of the consignor and the terms of the contract for transportation, and agreeing or directing that the freight be delivered to a specified person or his order at a specified place. A bill of lading serves three distinct functions: (1) as a receipt, (2) as a contract, (3) as evidence of the kind, quantity and quality of the goods shipped, and (4) as evidence of title. (See secs. 505 to 508 inclusive.)

The Uniform Bills of Lading Act defines a negotiable or order bill of lading as one "in which it is stated that the goods are consigned or destined to the order of any person named in such bill." (See sec. 509.)

(d) (1) Common carriers are insurers of goods in transit; that is, they are liable for loss, damage or destruction of merchandise entrusted to them for transportation, regardless of negligence.

(2) Common carriers are not, however, insurers of passengers; that is, they are not liable for injury to passengers unless it is occasioned by the carrier's negligence. A common carrier of passengers, however, must exercise the highest degree of care for the lives and safety of its passengers; hence, the passenger's burden of proof as to negligence is relatively slight.

1546. AI-NY Nov. 1945 (7). (a) Define a bill of lading.

(b) What is: (1) a straight bill of lading; (2) an order bill of lading?

(c) What four purposes are served by shipping goods under order bills of lading? Explain.

(d) Anson met Box and said to him, "For what will you sell me 500 barrels of flour?" Box replied, "Ten dollars a barrel, cash on delivery." Anson said, "All right, I accept; deliver the flour to my warehouse tomorrow morning." The next day flour dropped in value and was worth \$8 a barrel when Box tendered the flour to Anson the next morning. Anson refused to accept at the price agreed upon. What can Box do?

(a) See secs. 503 and 1545, subd. (c).

(b) See sec. 509.

(c) All bills of lading, whether straight bills or order bills, serve four functions: (1) as a receipt; (2) as a contract; (3) as evidence of the kind, quantity and quality of the goods shipped; and (4) as evidence of title. (See secs. 504-508). In addition, shipping goods under order bills of lading serves four purposes or presents four advantages from the standpoint of negotiability, that is, immunities from limitations to which ordinary transfers are subject: (1) immunity from defect in transferor's title, (2) immunity from judicial process by way of attachment or levy (unless the bill of lading is first surrendered or its negotiation enjoined), (3) immunity from stoppage in transit (unless the bill of lading is first surrendered for cancellation), and (4) immunity from liens or claims of a seller, shipper or prior transferor. (See sec. 509.)

(d) See sec. 1512, subd. (d).

1547. AI-NY Nov. 1945 (9). (a) What is the liability of a common carrier (1) of merchandise, (2) of passengers?

(b) A railroad company transported goods to their destination and notified the consignee that the goods were ready for delivery. The consignee did not call for the goods until a week later. The day before he called for the goods they were destroyed by fire without the negligence of the company. Is the railroad company liable for the loss of the goods? If so, why? If not, why not? Explain.

(c) A station agent of the X RR. Company, through error, quoted a lower freight rate to a shipper than the real rate. A contract was made to ship and transport goods at the quoted rate. When the error is dis-

covered by the railroad company, can the contract be rescinded by the carrier? Why? What principle is involved in this question?

(d) A shipper delivered goods to a railroad company for shipment. The train was derailed by train wreckers and the goods stolen. Can the shipper recover the value of the goods from the railroad company? If so, why? If not, why not? Explain.

(a) (1) A common carrier of merchandise is liable as an insurer; that is, he is responsible for loss regardless of negligence. (See sec. 501.)

(2) A common carrier of passengers is not liable in the absence of negligence. However, the law exacts from such carriers the highest degree of care in respect to passengers whom they transport. (See secs. 501 and 519.)

(b) On the assumption that the consignee had a reasonable opportunity to take the goods away before the fire occurred, the carrier was no longer liable as insurer when the fire occurred (sec. 515); and since the fire occurred without the company's negligence, the company was not liable as bailee.

(c) The contract can be rescinded by the carrier. "An interstate carrier of freight has both a right and a duty to recover the rate fixed by the published tariff, although the shipping contract specifies a different rate or otherwise violates the terms of the Interstate Commerce Act, and if it has collected less than the published rate it has both a right and a duty to recover the remainder, even though such rate be excessive, unreasonable, and unlawful. . . . The circumstance that the rate was agreed on or paid and accepted through mistake of one or both parties does not affect the operation of the rule requiring the established rate to be charged and paid, since both are bound to take notice of the filed tariff rates."¹²

(d) The shipper can recover the value of the goods from the railroad company, since a carrier of goods is liable as an insurer. The common exceptions to a carrier's liability as an insurer, such as acts of God and of the public enemy, do not apply here because train wreckers are not regarded, for such purposes, as "public enemies," however antisocial their conduct may be. The term "public enemies," in this connection, relates to external public enemies.

1548. NY Apr. 1943 (11). (a) State the difference between the liabilities of a carrier in the transportation of property and of passengers.

(b) What are the exceptions to the rule of its liability?

¹² 13 *Corpus Juris Secundum* 873-875 and the numerous cases therein cited.

(a) See secs. 501 and 519.

(b) A common carrier of goods is excused from liability as insurer if the loss, damage or destruction is due to (1) acts of God, (2) acts of a public enemy, (3) fault of the shipper, (4) acts of public authorities, or (5) inherent nature of goods. (See secs. 501 and 1543.) Moreover, a carrier may under certain conditions limit its liability. (See sec. 502.)

1549. AI Nov. 1935 (12). State the general principles underlying a common carrier's liability for loss or damage to goods shipped by freight.

See secs. 501 and 1547, subd. (a).

1550. AI May 1944 (9). (a) A ships goods by the Y R.R. Company, a common carrier. A agrees with the company in writing to limit the railroad company's liability for loss to an amount not exceeding \$250. The goods are lost and A sues for \$500 which he claims was the actual value of the goods. The company sets up as a defense the agreement.

Can A recover and if so how much?

(b) What constitutes proper delivery of goods by a common carrier to the consignee?

(c) When is a common carrier excused for a failure to deliver goods to the consignee?

(a) A can recover \$250 only. Under the Carmack Amendment to the Hepburn Act as subsequently further amended, although an interstate carrier cannot *exempt* itself from liability for negligence, it may, by agreement upon a maximum valuation, *limit* its liability for negligence, provided such limitation complies with the three conditions set forth in sec. 502.

(b) A carrier must make delivery at the proper time, to the proper person, and at the proper place. (See sec. 512.)

(c) See sec. 1543.

1551. NY Apr. 1942 (14). (a) What is a bill of lading?

(b) Name and describe each class.

(c) What are the essential features of a bill of lading?

(a) See sec. 1545, subd. (c).

(b) The Uniform Bills of Lading Act defines a negotiable or order bill as one "in which it is stated that the goods are consigned or destined to the order of any person named in such bill." It defines a nonnegotiable or straight bill as one "in which it is stated that the goods are consigned or destined to a specified person." (See sec. 509.)

(c) Every bill of lading must embody within its written or printed terms at least the following: (a) date of issue, (b) name of person from whom goods have been received, (c) place

where goods have been received, (d) place to which goods are to be transported, (e) statement whether goods received will be delivered to a specified person or to the order of a specified person, (f) description of goods or of packages containing them, and (g) signature of carrier.

A bill of lading serves four functions: (1) as a receipt, (2) as a contract, (3) as evidence of the kind, quantity and quality of the goods shipped, and (4) as evidence of title. (See secs. 505 to 508 inclusive.)

1552. NY Apr. 1941 (2). (a) Define bill of lading and state what it represents and how it is regarded in commercial law.

(b) When are freight charges payable to a common carrier?

(a) See secs. 1545, subd. (c) and 1551, subds. (b) and (c).

(b) A common carrier may require freight charges to be paid in advance; if not so paid, the carrier may refuse to receive the goods.

1553. NY Apr. 1940 (10). (a) Define the term *bill of lading*.

(b) What is a negotiable bill of lading?

(c) What is an essential in a negotiable bill of lading?

(d) If before delivery of a shipment the consignee has indorsed a negotiable bill of lading to his creditors, will this affect the usual right of the consignor to stop the goods in transit?

(e) State your reasons for your answer to (d).

(a) See sec. 1545, subd. (c).

(b) See sec. 1545, subd. (c).

(c) See secs. 509 and 1545, subd. (c).

(d) The consignor is barred by such indorsement from stopping the goods in transit.

(e) When a negotiable bill of lading is issued, an unpaid seller cannot, by stoppage in transit, defeat the rights of a purchaser for value in good faith to whom such bill has been negotiated (sec. 509, subd. (3)). Indorsement of the bill of lading to the consignee's creditors would be the equivalent to negotiation of the bill to purchasers for value.¹³ Presumably, the creditors took the bill in good faith and without knowledge of circumstances justifying the consignor in stopping the goods in transit.

¹³ In *National Bank of the Republic v. Hines*, 112 Wash. 352, 192 P. 899, it was held that prior indebtedness to a bank constituted sufficient consideration to give the bank, as indorsee of a bill of lading, the rights of a holder for value.

1554. NY Apr. 1944 (4). (a) State with which railroad a manufacturer of Rochester, N.Y., should file his claim for damages on each of three shipments, as follows:

(1) To Westport, N.Y., which the N.Y.C. turned over to the D & H at Albany, N.Y.

(2) To Williamsport, Pa., which the N.Y.C. turned over to the P. RR. at Canandaigua, N.Y.

(3) To Oneonta, N.Y., which the N.Y.C. turned over to the D.L. & W. at Utica, N.Y. and which was turned over to the D & H at Sidney, N.Y.

(b) Explain your answers to (1) (2) and (3) of (a).

(a) (1) N.Y.C.

(2) N.Y.C.

(3) N.Y.C.

(b) The first and third of the above shipments were *intra-state*, the second *interstate* (secs. 59 and 494). The New York rule governing intrastate shipments is the same as the Federal rule governing interstate shipments, namely, that connecting carriers are treated as agents of the initial carrier, and the latter is liable for any loss or damage occurring during the shipment, whether on its own line or on that of the connecting carrier. (In some states, the old common law rule still obtains in respect to intrastate shipments, namely, that when an initial carrier delivers goods in good condition to the connecting carrier, his liability ceases, and the shipper must look to the connecting carrier for any loss or damage occurring thereafter, unless the initial carrier accepts the goods for *through transportation*, in which case the initial carrier assumes complete liability for the shipment throughout.)

1555. AI May 1941 (6). A certified public accountant completed an out-of-town engagement and returned to his home-office city by railroad. He purchased a one-way ticket with Pullman accommodations and checked a large brief case and a suitcase as baggage. There was no excess baggage charge. The brief case and the suitcase were carried on the same train with the accountant but for some unknown reason the brief case could not be found by the carrier at the end of the journey. No questions had been asked by the railroad agent concerning the contents of either case and the passenger had volunteered no information about them. The brief case contained working papers, the replacement of which would cost over \$1000. Is the carrier legally responsible for the loss of the brief case as baggage?

Under the rule enunciated in sec. 521, the brief case and working papers would be classed as baggage, and the carrier would be responsible for their loss.

The English and American rules on this point seem to be at variance, though the decisions are not recent.

In the English case,¹⁴ the question for the Court was whether an attorney, traveling as a passenger on a railway, was entitled to carry with him his portmanteau, as ordinary luggage, and the deeds and documents which were required as evidence on a trial which he was going to attend, and it was held that he was not.

On the other hand, in an early American case,¹⁵ it was held that "With a lawyer going to a distant place to attend court, with the author proceeding to his publisher's, with the lecturer traveling to the place where his engagement is to be fulfilled, manuscripts often form, though a small, yet an indispensable part of his baggage. They are carried, as such, in his trunk or portmanteau, among his other necessary effects. They are indispensable to the object of his journey; and, as they are carried with his baggage in accordance with custom, I see no reason why they should not be deemed as necessary a part of his baggage as his novel or his fishing tackle."

In another early American case,¹⁶ the Court held that manuscript books, the property of a student, and the papers and books of a lawyer in a trunk, are baggage.

1556. NY Apr. 1939 (13). (a) What is the purpose of the Interstate Commerce Act?

(b) What are the main provisions of this law?

(c) What carriers are subject to the provisions of this act?

(a) "The principal objects of the Interstate Commerce Act were to secure just and reasonable charges for transportation; to prohibit unjust discriminations in the rendition of like services under similar circumstances and conditions; to prevent undue or unreasonable preferences to persons, corporations, or localities; to inhibit greater compensation for a shorter than for a longer distance over the same line; and to abolish combinations for the pooling of freights."¹⁷

(b) Among the provisions of the Interstate Commerce Act are the following:

(1) It prescribes the duty on the part of any common carrier engaged in the transportation of passengers or property

¹⁴ *Phelps v. London, etc. Ry. Co.*, 19 J. Scott, N.S. (115 E.C.L.) 321.

¹⁵ *Hopkins v. Westcott*, 12 Fed. Cas. 495.

¹⁶ *Hannibal v. St. J. R. Co. v. Swift*, 79 U.S. (12 Wall.) 262, 269, 20 L. Ed. 423.

¹⁷ *Interstate Commerce Commission v. Baltimore & Ohio R. Co.*, 145 U.S. 263, 276.

to provide and furnish such transportation upon reasonable request.

(2) It establishes reasonable rates for transportation, fares, and so on.

(3) It establishes classifications of property for transportation and requires the filing of rates and schedules in respect thereto.

(4) It prohibits free transportation of passengers except to employees and their families, and officers, agents, surgeons, physicians and attorneys at law employed by interstate carriers; also excepting ministers of religion, traveling secretaries to railroad Y. M. C. A.'s, inmates of hospitals and charitable or eleemosynary institutions, and persons exclusively engaged in charity; inmates of homes, disabled soldiers and sailors, railway mail service employees, employees on sleeping cars, express cars and linemen of telegraph and telephone companies; post office inspectors, customs inspectors and immigration inspectors; newsboys on trains; baggage agents; witnesses attending a legal investigation in which the common carrier is interested; and persons injured in wrecks, as well as physicians and nurses attending such persons.

Any common carrier violating this provision is deemed guilty of a misdemeanor and may be required to pay a penalty of not less than \$100 and not more than \$2000. Persons using free passes, who are not thus exempted, are also subject to similar penalty.

(5) Combinations or consolidations of railroad companies and their carriers, engaged in interstate commerce, are not permitted without the approval of the Interstate Commerce Commission.

(6) No railroad company subject to Federal regulation can extend or abandon its lines without first procuring a certificate of approval therefor from the Interstate Commerce Commission.

(7) The Interstate Commerce Commission has power to require adequate facilities or extensions of lines.

(8) Special rates and rebates are prohibited.

(9) The act further provides for the establishment of a commission with authority requisite to the discharge of duties and powers created by the act.

(10) The commission prescribes uniform accounts and requires the filing of regular reports.

(11) The act provides for fair return on investment and prescribes a basis for determining fair return.

(12) The act establishes liability as between initial carrier and connecting carrier on through shipments.

(c) Generally speaking, carriers engaged in interstate commerce are subject to the provisions of the Interstate Commerce Act. Originally the jurisdiction of the Interstate Commerce Commission created by the Act was limited to common carriers engaged in the transportation of passengers or property "wholly by railroad or partly by railroad and partly by water when both are used under a common control, management, or arrangement for continuous passage or shipment." This jurisdiction has since been extended to include express companies, pipe lines (except for water or gas), sleeping car companies, the "transmission of intelligence by wire or wireless," and the transportation of passengers and property by motor carriers engaged in interstate or foreign commerce.

CHAPTER VI-A

Agency

1557. NY Oct. 1943 (4). Compare or contrast an agent with (a) an independent contractor, (b) a trustee, (c) an escrow holder.

(a) An agent is subject to the control and supervision of the one who employs him; but this is not true of an independent contractor. Hence, for the contracts and torts of an agent in the course of his employment, a principal, who has the right to control him, is liable. But for the contracts and torts of an independent contractor who has complete charge and supervision of the work that he does for another, the latter is not liable.

(b) There are three differences between an agent and a trustee: (1) An agent has no title to the property he handles. A trustee has the legal (but not equitable) title to the property in his custody. (2) An agent acts in the principal's name. A trustee acts in his own name. (3) An agency may generally be revoked by the principal at any time (sec. 577). A trustee, as a rule, retains his authority until the purpose of the trust is fulfilled, and can be removed only for cause.

(c) An agent acts for a principal in dealing with third parties. He cannot act for both principal and third party, if their interests conflict. An escrow holder acts for two adverse parties in accepting and holding some instrument or thing of value, such as a deed, document of title, money or securities, deposited by one of the parties for delivery to the other upon the happening or fulfilment of a condition. An agent's authority may generally be revoked at any time by the principal. An escrow holder's authority is irrevocable, except upon the consent of all parties.

1558. AI-NY Nov. 1945 (5). (a) A person gratuitously undertakes to do an act for another.

(1) What is his liability if he omits to do it, and loss thereby occurs?

(2) What is his liability if he attempts to do it and does it so negligently that loss occurs?

(b) Ajax, conducting a business under his own name, made his promissory note to Brown's order for a purchase of goods. Later Brown discovered that Ajax was in fact conducting the business as agent for Coates. The note was not paid at maturity. What are Brown's rights? Discuss fully.

(c) An agent was instructed by his principal to purchase certain bonds at a certain price on a certain date. The agent was informed from sources which he believed to be reliable that the next week the bonds would be lower in price. He waited, but the bonds increased in price above what they were on the day the agent should have bought them. Is the agent personally liable for the extra cost? Explain.

(a) (1) If one gratuitously promises to act as agent for another, and then changes his mind, neither of the parties becomes obligated to the other, since an executory contract unsupported by consideration is unenforceable (sec. 144).

(2) On the other hand, once a person, pursuant to a gratuitous promise, embarks upon an agency on behalf of another, the latter is entitled to assume that the agency will be discharged with reasonable fidelity and care; and for a failure to do so, the gratuitous agent becomes liable to his principal for consequent loss. (See sec. 555.)

(b) So far as concerns liability on the note itself, Brown has no valid claim against Coates, since an undisclosed principal is not chargeable on a promissory note if his name does not appear thereon. See secs. 264 and 570, subd. (3). However, since it appears that Coates has had the benefit of the transaction, Brown may reject the note and recover on the original consideration for the contract. "Where the undisclosed principal has obtained the benefits of the transaction in which the note was given by the agent, which in equity he ought not to retain, the third person may reject the note and recover on the common counts or on the original consideration for the contract. Thus it has been held that the third party could ignore notes given for the purchase of land by the agent and sue the undisclosed principal for the purchase price as evidenced by the contract of sale signed by the agent."¹

(c) The agent is liable for the extra cost. His specific instructions left no room for discretionary deviation therefrom. In other words, as a ministerial, not a discretionary agent, he should have obeyed his instructions implicitly. For loss occasioned by departure from such instructions, the agent is liable. (See sec. 563.)

¹3 *Corpus Juris Secundum* 175.

1559. AI May 1937 (2). A certified public accountant was making a balance-sheet audit of a coal dealer's business and the accountant, at his own expense, engaged an engineer to survey coal piles and to report to the accountant the quantity in each pile. The engineer in the due performance of his work purchased necessary supplies for which he did not pay. Has the vendor of these supplies an enforceable claim against the accountant?

The vendor has no enforceable claim against the accountant. See sec. 546, subd. (b), Example (1).

1560. AI Nov. 1937 (7). (a) In a state where a person becomes of age at twenty-one years, is a minor twenty years old legally qualified to be a principal and as such to appoint an agent?

(b) In such a state, is a minor twenty years old legally qualified to act as agent for another person as principal?

(c) What elements or factors must be found to constitute an agency by ratification?

(d) Can a corporation ratify an act by a promoter prior to incorporation?

(e) Can one whose signature has been forged ratify the act of the forger?

(a) The minor in question is legally qualified, as principal, to appoint an agent. In most states the appointment of an agent by an infant principal is valid, but voidable at the option of the infant, unless such appointment is a necessity and not a luxury to the infant, in which event the infant is bound. In some states (New York, for example) the statute provides that an infant's business contracts (and this would include the appointment of agents) are binding on the infant provided they are reasonable and provident, and provided the infant is eighteen years of age or over.

(b) The minor in question would be clearly qualified to act as agent. Any person may be an agent (except infants of tender years, lunatics, imbeciles, and so on), because the agent's acts are not his own, but his principal's; the infant being only a medium or conduit through whom the transaction passes or flows.

(c) The elements or factors which must be present to constitute an agency by ratification are: (1) validity of act to be ratified, (2) competency of principal to ratify, (3) the act must have been done in the name and on behalf of the person who ratifies it, (4) the ratification must be with full knowledge of the facts, and (5) the ratification must cover the entire act. (See section 552.)

(d) A corporation is not competent to ratify an act performed on its behalf before the corporation came into existence,

because one cannot act as agent for a nonexistent principal. However, a corporation can *adopt* such an act so as to become liable on it (sec. 744).

(e) One whose signature has been forged may ratify the act of the forger only to the extent of becoming contractually liable on the instrument; but he cannot, by ratification, wash out the crime (see sec. 552, subd. (a)).

1561. NY Apr. 1938 (11). In determining the validity of a contract entered into by a person (a minor) acting as agent for his principal, what factors should be considered? Explain.

In determining the validity of a contract entered into by a minor acting as agent for his principal, one should bear in mind that such contract is not the minor's, but the principal's. The minor is only a medium, or conduit, through whom the transaction passes or flows. Therefore, only the legal capacity of the principal is material in such a case. So far as the agent is concerned, the only requirement on his part is that he possess sufficient physical and mental capacity to exercise the authority delegated to him. Anyone, therefore, except a lunatic, imbecile or infant of tender years may act as agent for another; and a contract so negotiated will not be invalidated merely because the infant agent lacks contractual capacity to act for himself.

1562. AI-NY May 1945 (4). (a) Aaron appointed Barrow, who was seventeen years of age, his agent to buy certain goods. Barrow bought the goods but Aaron refused to take them, claiming that the contract was not good because of Barrow's infancy. Can Aaron be held on the contract Barrow made?

(b) Anderson owned land. He gave Barclay power under seal to sell and convey the land. Barclay sold it. In the body of the deed which he delivered, the grantor was named as "Barclay, agent of Anderson." The deed was subscribed "Barclay, agent of Anderson." In jurisdictions where land may be conveyed by an agent, did the deed pass legal title? What are the reasons?

(c) Carr Co. gave credit to Allison, who was really the agent of Brown. The agency was unknown at the time but it was discovered by Carr Co. after Brown failed. Could Allison, the agent, be held? Explain.

(a) Aaron is bound. The infancy of his agent, Barrow, is immaterial: the purchasing contract negotiated by Barrow was Aaron's contract, not Barrow's. (See secs. 548 and 1561.)

(b) The deed will not pass legal title. Had the body of the instrument named Anderson as grantor, the answer would be otherwise. However, since Barclay, the agent, was named as

grantor in the body of the deed, and since he likewise signed as such grantor, the words "agent of Anderson" must be treated as purely descriptive.

Under the early common law rule, the deed would not have passed legal title even if the body of the instrument had sufficiently designated Anderson as the principal. This was upon the theory that when one signs, "A, agent for B," the signature will be deemed that of the agent, and the words "agent for B" will be deemed purely descriptive, even though the body of the instrument clearly designates the true principal. The courts have now for the most part abandoned the ancient rule, preferring the more reasonable rule that where the agency truly exists, and the act sufficiently appears to be that of the principal, the mere fact that the agent's name is signed, followed by a designation of his agency, will not prevent the signature from being construed as that of the principal. Thus, in the case of *Robbins v. Austin*,² the deed purported to be the grant of the principal by her attorney under a power, and the attestation clause spoke of the principal as setting her hand and seal to the deed, which was signed, "A, attorney, by B" (the principal). The Court held that the deed sufficiently appeared to be that of the principal.

(c) Allison could be held. When the principal is undisclosed at the time of the contract, and the third party later ascertains the principal's existence or identity, such third party may elect to hold either the undisclosed principal or the agent. (See secs. 569 and 574.)

1563. NY Apr. 1936 (1). When must an agency be created by an instrument under seal? Would it be necessary to create an agency by an instrument under seal to authorize an agent to enter into a contract for the sale of land?

An agent who must execute instruments under seal, must be appointed by an instrument under seal. A contract to sell land need not be under seal, and an agent may enter into such a contract without having to affix a seal to the instrument. Hence an agent's authority to execute such a contract need not be under seal.

There are a number of exceptions to the rule that an agent who is required to execute instruments under seal, must be appointed by an instrument under seal:

² 42 Hun. 469, 6 N.Y. St. Rep. 30.

(a) When the agent signs in the presence of his principal. Here the effect is the same as if the principal had signed the instrument himself.

(b) Where the seal, though affixed to the contract, was not actually required by law. Some states, such as New York, California and Kentucky, have abolished, in large part, the distinction between sealed and unsealed instruments. In such states, a seal affixed to an instrument is often unnecessary, and oral authority to execute such instrument on behalf of a principal is sufficient.

(c) When the agent signs as a partner for his firm. Here the agency exists, not by appointment, but because of the partnership relation.

(d) When an agent signs for a corporation. Here the agent's authority to affix the corporate seal need merely be conferred by a vote of the board of directors.

1564. NY Oct. 1941 (6). (a) Define *ratification* as affecting agency.

(b) Can a principal ratify his agent's acts which were beyond the powers committed to the agent?

(c) Can an unauthorized signature be ratified?

(d) Can a corporation ratify agreements which were made by its organizers before its incorporation?

(a) Ratification, in agency, is the approval of an unauthorized act done by an agent who exceeds his authority, or by one who, without authority, purports to act as agent.

(b) Yes. See subd. (a).

(c) See secs. 1560, subd. (e) and 552, subd. (a).

(d) See sec. 1560, subd. (d).

1565. AI May 1940 (1). X, an agent, had sold \$210,000 insurance on the life of Y, payable to Z. In 1939 Y was seventy-three years old but in good health. Y had borrowed the maximum amount obtainable on this insurance and was about to let it lapse because he was unable to pay the quarterly premium of approximately \$2000 due in February. X orally urged Z, who knew all the facts, to pay this premium but no mention was made of compensation to X for this advice. Induced by X's urging, Z made the payment and upon Y's death in April, 1939, Z collected approximately \$86,000 on this insurance. X now demands that Z pay X, for the reasonable value of X's service to Z, ten per cent of Z's net recovery of approximately \$84,000. Has X a right to collect any amount of compensation from Z?

X does not have a right to collect compensation from Z. X's services were obviously gratuitous, and without express

or implied agreement as to compensation. See sec. 556, Example (3).

1566. NY Oct. 1940 (4). Smith owns a rare book. He asks Jones, who is about to go abroad, to take it from New York to Paris, to sell it at not less than \$5000, to reimburse himself for all his expenses and to remit the balance to Smith. On his journey to Paris, Jones spends \$748 and upon his arrival in Paris, he receives a cable from Smith revoking the agency. Under these circumstances state your opinion as to the respective rights of Smith and Jones.

Smith's revocation is subject to a lien in favor of Jones for the amount of the latter's expenses, provided such expenses were necessarily incurred on Smith's behalf. If they were not, Smith would have a right to terminate the agency without obligation to Jones, since the agency was obviously terminable at will. (See sec. 560.)

1567. NY Oct. 1942 (10). (a) To whom may an agent become personally liable?

(b) In what ways may an agent become personally liable?

(a) An agent may become personally liable to his principal and to third parties.

(b) An agent may become personally liable for breach of his duties and obligations to his principal. (See secs. 562-565 for specific instances of liability arising from a breach of such duties.)

An agent may also become personally liable to third parties, (1) by acting for a nonexistent or incompetent principal, (2) by acting for an undisclosed principal, (3) by misrepresenting the extent of his authority, (4) for moneys wrongfully received, (5) on obligations personally assumed, or (6) in tort. (See sec. 574.)

1568. NY Apr. 1941 (6). A certified public accountant of the State of New York was engaged by a client to design a proper system of accounting and other records for a corporation in another state. Because the accountant was not fully informed as to the laws of the other state, he did not provide for certain records required by its laws.

(a) Is the certified public accountant liable for damages resulting to the client from this omission?

(b) Give reasons for your answer.

(a) The certified public accountant is liable.

(b) If an accountant undertakes to advise professionally on a matter outside the scope of his knowledge, experience and training, he renders himself liable to his client for any consequent loss due to any professional inadequacy in rendering the

services in question. An accountant in such situations, like any other agent, must possess the degree of skill, care and diligence which the circumstances require. In the situation stated, the accountant impliedly warranted that he had the necessary skill and training and would exercise the necessary care and diligence required to perform the task properly. (See sec. 564.)

1569. NY Oct. 1942 (1). A certified public accountant issues a written and signed opinion stating that a balance sheet correctly shows the position of a corporation at a stated date. However, the balance sheet is erroneous in that it overstates the position by the inclusion of items not owned or by the omission of liabilities, either error being intentional or resulting from a culpable neglect of accepted auditing procedures.

To what penalties may the accountant be subjected?

To the extent that the balance sheet overstated the position by including items not owned or by omitting liabilities, the accountant was guilty of making a false entry in the statement of one's financial condition. On the assumption that such inclusions and omissions were wilful, the accountant would be guilty of forgery in the third degree under Section 889 of the Penal Law of the State of New York,³ which provides that the making of a false entry in the statement of a person's financial condition or the wilful omission of material entries in such account, if made with intent to defraud creditors or to conceal a crime or to conceal from creditors or stockholders or other persons interested, matters materially affecting the financial condition of an individual or business concern—constitutes forgery in the third degree.

In addition, civil penalties by way of damages would be imposed, since a false or negligent certification that a balance sheet correctly shows a given business position at a stated date whereas, in fact, it does not, subjects the certifying accountant to an action for damages. A public accountant is thus responsible not only to persons who employ him, but also to creditors and investors to whom the employer may exhibit the accountant's certified balance sheet or financial statement.⁴

1570. AI May 1942 (2). *P*, a wholesaler, appointed *B* as his general agent for the sale of flour in Chicago and instructed him not to sell below the market price and not to give the usual warranties of quality which were given by other salesmen in the Chicago area. In violation of these

³ This being a New York question.

⁴ *Ultramares Corporation v. Touche, Niven, et al.*, 255 N.Y. 170.

instructions *B* sold flour to *C* at less than the market price and with a warranty of quality similar to that given by other salesmen. The flour was delivered to *C* who paid for it at the reduced price. It was not of the quality represented. What are the rights of the parties as against each other?

P, the principal, is bound not only by the lower price, but also by the warranty of quality. *B*, as a general agent, was acting within the apparent scope of his authority, and *C*, the third party, was unaware that *B* was deviating from his instructions. *B*, however, is liable to *P*, his principal, for violation of the duty of obedience to the principal's instructions in such amount of damages as *P* may prove in consequence of such breach of duty.

1571. AI Nov. 1943 (1). (a) In what cases is the principal liable upon a contract duly made by his agent with a third person?

(b) What are brokers and factors?

(c) Define attorneys at law and attorneys in fact.

(d) How should an agent execute negotiable paper?

(a) A principal is liable upon a contract duly made by his agent with a third person in the following situations: (1) when the contract was expressly or impliedly authorized; (2) when the contract, though originally unauthorized, was subsequently ratified; and (3) when the contract, though neither authorized in the first instance nor subsequently ratified, was made under circumstances from which the third party had a right to assume that the agent was duly authorized, that is, when the contract is made by a general agent acting within the apparent scope of his authority (sec. 567).

(b) Brokers are agents authorized to negotiate the sale of real or personal property. Factors (also known as commission merchants) are agents who, acting usually in their own names, sell or dispose of merchandise consigned to them by a principal. Though both brokers and factors may be agents to sell, brokers, unlike factors, are not usually entrusted with possession, control and disposition of the property concerned, nor may they bind their principal by buying or selling property in their own names.

(c) An attorney at law is a person specially qualified to represent other persons, known as clients, in matters of a legal nature. An attorney in fact, in a strictly legal sense, means an agent acting under a special power created by some instrument or deed, such as a "power of attorney." In a loose sense, how-

ever, the term *attorney in fact* is frequently employed to mean all agents except attorneys at law.

(d) An agent should execute negotiable paper in his principal's name, not his own. For example, he should sign, "Henry Brown by John Mason, agent," not "John Mason, agent"; otherwise he may become personally liable to a holder in due course. However, as to a payee, the rule is somewhat different. When a person signs as agent without disclosing his principal and the payee knows that he is acting as agent and does not intend to bind himself individually, the agent, if actually authorized to sign for the principal, is not personally liable to the payee; and the principal is not liable in such case, either, since his name is not on the instrument (see sec. 264).

1572. AI Nov. 1941 (3). Where, under an agency contract, the agent is legally permitted but not expressly authorized to appoint a subagent, how does such an appointment affect the agent's legal responsibility to his principal?

When an agent is legally permitted but not expressly authorized to appoint a subagent, the question of whether the agent is legally responsible to his principal for such an appointment depends upon whether the appointment is impliedly authorized by the principal, that is, whether it is reasonably necessary and incidental to the fulfillment of the purposes of the agency. If, by this test, the subagency is impliedly authorized, the subagent becomes the principal's agent (not the agent's agent), and the agent, having violated no duty to his principal, is in no wise liable to the principal. If, by the same test, the subagency was unwarranted, yet was within the apparent scope of the agent's authority so that the subagent had a right to assume that the subagency was duly authorized, the principal would be liable to such subagent, but the agent would be liable for consequent damages to his principal in overstepping the actual bounds of his authority. If the subagency was not within the apparent scope of the agent's authority, the subagent could not hold the principal, but he could hold the agent on the latter's breach of express or implied warranty that he had authority to hire a subagent.

1573. NY Apr. 1944 (11). A manufacturer who occupied rented premises mentioned to an accountant who was working on his books (an employee of the auditors but not a partner in the firm) that he proposed to sublet a large part of the premises, because his business was badly affected by priorities and other war conditions. Learning that the manufacturer

had no counsel, the accountant offered to draw up the necessary papers for a fee of \$20. The manufacturer accepted this offer and paid the fee; he also spent a considerable sum in removing and relocating his own equipment, only to find that he could not enforce the so-called contract and that his action had made him liable to his landlord. Can he recover from the firm of auditors? Explain.

The manufacturer cannot recover from the firm of auditors. A person who engages in the practice of furnishing legal advice or drawing up legal papers other than on his own behalf, without having been admitted to the practice of the law, is guilty of unlawfully practicing law. Such practice in New York and other states constitutes a misdemeanor (sec. 45). A principal is not liable for an agent's crimes unless the principal directed, aided, abetted or knowingly acquiesced in such crimes. Even in jurisdictions where the act in question constitutes no crime, it would constitute a wrong corresponding to a tort. A principal is not liable for an agent's torts unless they are committed within the course and scope of the agent's employment. The acts in question were no part of the employee's duties on behalf of the firm of auditors by whom he was employed. Only where employers knowingly permit an employee to engage in such acts can they be held liable in connection therewith (see sec. 571).

1574. NY Oct. 1937 (1). Name *four* ways in which an agent may become personally liable to third persons.

See sec. 1567.

1575. AI Nov. 1936 (7). An infant, twenty years of age, authorized his agent to purchase certain bonds, the agent knowing the infancy of his principal. The agent purchased the bonds, disclosing the name of his principal but not disclosing the fact of infancy. The vendor did not know that the principal was an infant and the agent had every reason to believe that the vendor was ignorant of this fact. Upon reaching the age of twenty-one, the infant disaffirmed the purchase, returned the bonds and all interest received thereon, and was reimbursed for the purchase price. Is the agent legally responsible to the vendor?

The agent is legally responsible to the vendor. "One professing to contract as agent is personally liable, if, unknown to the other party, his purported principal is actually nonexistent, or legally incompetent or irresponsible, for the agent impliedly represents or warrants that his principal has existence or legal competency and he must see that his principal is bound, or he himself will be liable. . . . The rule applies notwithstanding good faith on the part of the agent, with an exception that if

unknown to him his authority has been revoked by the death of the principal, he will not be held responsible. The agent is not liable where the third person has knowledge of the non-existence or incompetency of the principal, or where there is an agreement or understanding to the contrary.”⁵

1576. AI Nov. 1939 (1). State several conditions or circumstances in which a duly appointed agent may become personally liable to third persons with whom he deals.

See sec. 1567.

1577. NY Oct. 1936 (2). Mention *five* ways by which the relations between principal and agent may be terminated by operation of law.

Five ways in which the relations between principal and agent may be terminated by operation of law are: (1) illegality of subject matter, (2) destruction or loss of subject matter, (3) death or incapacity of the parties, (4) dissolution of business, and (5) bankruptcy or insolvency. (See sec. 579.)

1578. NY Oct. 1938 (1). (a) What is an agency coupled with an interest?

(b) State the distinction between a general agent and a universal agent.

(a) An agency coupled with an interest is one which gives the agent an interest in the subject matter of the agency itself, as distinguished from a mere interest in connection with the agency. (See sec. 581.)

(b) A general agent, as distinguished from a special agent, is one who has broad authority to represent his principal, and for whose acts a principal is liable, not only when they have been actually authorized by the principal, but even when they have not been authorized, provided they are of such a nature that third parties have a right to assume that such authority exists (see sec. 542).

A universal agent is one whose authority is even broader than that of a general agent; he is empowered (usually by an unlimited power of attorney) to do all things for a principal that the principal might do for himself (except those things which a principal from the very nature of things cannot physically or legally delegate to another). (See sec. 542.)

1579. AI May 1939 (3). When and in what circumstances may a general agent renounce his agency and terminate his relationship with his principal without incurring liability to the principal?

⁵ 3 *Corpus Juris Secundum* 118-119.

A general agent may rightfully renounce or abandon his agency where: (1) the principal violates the agency agreement, as by refusing to pay agreed compensation, to repay disbursements, or to indemnify the agent; (2) the agency is gratuitous; or (3) the agency is terminable at the will of either party.

1580. **AI May 1940 (8).** *A* and *B* execute a written contract whereby *A* employs *B* "permanently." There are no other stipulations, either express or implied, as to the duration of the employment and the only consideration given by *B* is his agreement to render "permanently" the services specified in the contract.

(a) For how long a period of time will this contract continue in force?

(b) If *B*, in addition to his agreement to render the services, had as further consideration relinquished a business which he had been conducting, how if at all would your answer to (a) be modified?

(a) This contract will continue in force at the will of either party. The term *permanently* does not signify employment for a lifetime but, rather, relatively steady employment.

(b) The fact that as further consideration for the employer's agreement, the employee relinquished a business which he had been conducting would not modify the answer to (a).

In *Arentz v. Morse Dry Dock & Repair Co.*,⁶ the plaintiff agreed to give up his business and profession as a shipmaster and to enter into the "permanent employment" of the defendant, who conducted a dry dock and ship repairing business, in the capacity of assistant to the vice president and general manager. On suit for breach of contract the Court, in sustaining a judgment dismissing the complaint, said (page 443): "An agreement to give a person permanent employment means nothing more than that the employment is to continue indefinitely and until one or the other of the parties wishes for some good reason to sever the relation. . . ."⁷

"All these cases differ from those in which, from the circumstances of the case and from the consideration which has been furnished, it is evident that one party intended to employ the other for life or a definite period. . . .

"It must follow, therefore, that the employment of this plaintiff by the defendant was in a steady position as assistant

⁶ 249 N.Y. 438.

⁷ Citing *Lord v. Goldberg*, 81 Cal. 596, 22 P. 1126; *Rape v. Mobile & Ohio R. Co.*, 136 Miss. 38, 100 So. 585; *Texas & Pacific Ry. Co. v. Marshall*, 136 U.S. 393, 10 S. Ct. 846, 34 L. Ed. 385; *Perry v. Wheeler*, 12 Bush (75 Ky.) 541.

or general manager, to continue at the will of the parties. Plaintiff was not obliged to stay with the defendant for life, neither was the defendant obliged to employ him beyond the time when in good faith it had no further use for his services. The complaint, therefore, was properly dismissed by the trial judge at the end of the plaintiff's case for the reasons here stated."

1581. AI May 1944 (1). *A* is indebted to *B*, his agent. *A* gives the agent *B* authority to sell certain goods and from the proceeds to pay himself (*B*) the debt due from *A*. The principal *A* dies before the goods are sold.

(a) Would death of *A* revoke the agent's authority? Why?

(b) The executor of *A*'s estate seeks to recover the goods from the agent. Can he do so? Why?

(c) Can an agent appoint a subagent? Explain.

(d) Are there any exceptions to the general rule? If so, what are they?

(e) What are the legal consequences of an agent's unauthorized delegation of authority?

(a) *A*'s death would revoke the agent's authority unless it was more than a mere agency as security. Ordinarily the creation of an agency as security for a debt is not terminable by the principal during his lifetime without the agent's consent; but it is terminable by the principal's death unless the security is supported by a transfer of interest, as by the assignment of an account⁸ or some other interest "engrafted" on the subject matter of the agency itself.⁹ (See sec. 581.)

(b) The executor of *A*'s estate may recover the goods from the agent if the agency is merely one for security only, with nothing further. See (a).

(c) An agent may appoint a subagent when such appointment is actually or impliedly authorized by the principal. Whether a principal becomes liable to subagents and employees who are hired by a general agent without actual authority to do so, depends upon whether such act of the agent is within the apparent scope of his authority; that is, whether the subagents or employees would have a right to assume that the agent was authorized to hire them. See, in this connection, sec. 567, "Authority to hire subagents and employees"; also sec. 1572.

(d) The exceptions to the rule that an agent may not ap-

⁸ *Shepard v. McNail*, 122 Mo. A. 418.

⁹ 2 *Corpus Juris Secundum* 1176.

point subagents unless authorized to do so are covered in subd. (c).

(e) Where the appointment of a subagent is unauthorized and hence repudiated by the principal and where such appointment is not within the apparent scope of the agent's authority so that the subagent had no right to assume the existence of such authority, the subagent may hold the agent liable on an implied warranty by the agent that he was authorized to make the appointment. (See also sec. 1572.)

1582. AI Nov. 1940 (7). Brown, a licensed real estate broker, notified Jones that certain real property could be purchased from the Security Bank. Jones, who knew that Brown would be entitled to a commission, falsely told him that he was not interested in purchasing the property. Immediately thereafter Jones signed a contract with the bank for the purchase of this property, falsely representing to the bank that no broker had brought about the sale. Brown was unable to collect a commission. If Brown has any legal rights against Jones, on what principle of law would they be based?

Brown has no legal rights against Jones. Regardless of the value of his services, a broker, in the absence of a contract of hiring, express or implied, is not entitled to commissions.¹⁰ "In effect all that plaintiff did here was to bring the property to the attention of the ultimate purchaser. This gives the broker no right to a commission."¹¹

Presumably, the expression that Jones "knew that Brown would be entitled to a commission" is to be interpreted as meaning that Jones thought Brown would be entitled to a commission. This erroneous assumption does not affect the fact that when Jones told the bank that no broker "brought about the sale," he was not guilty of misrepresentation so far as concerned the nonexistence of liability to any broker. (See sec. 585, "Right to commissions: necessity of contract.")

1583. NY Apr. 1937 (11). (a) May a stockbroker use as collateral for his bank loan securities deposited by, or purchased for, a customer, which the broker is holding for the customer's debt?

¹⁰ *Morrill v. Barneson*, 30 Cal. App. 2d 598, 86 P. 2d 924; *Doll v. Albert Weiblen Marble & Granite Co.*, 207 La. 769, 22 So. 2d 59; *Rogers v. Garrigues* (Md.), 45 A. 2d 277; *Longmire v. Diagraph-Bradley Stencil Mach. Corporation* (Mo. App.), 176 S.W. 2d 635; *P. J. Spitz Co. v. Warner & Swasey Co.* (Ohio), 52 N.E. 2d 758; *In re Real Estate Trust Co. of Philadelphia*, 158 Pa. Super. 189, 44 A. 2d 608; *Willingham v. Thompson*, (Tex. Civ. App.), 133 S.W. 2d 833.

¹¹ *Newberry & Co., Inc. v. George W. Warnecke & Co., Inc.*, 267 App. Div. 418.

(b) Are there any limitations on the stockbroker as to the use of his customer's securities?

(a) A stockbroker may use the securities as collateral for his bank loan.

(b) A broker may repledge his customer's securities only to the extent of his lien, and upon condition that he retains control of the stock (that is, retains the right to reclaim it) so that if and when the customer's debt is paid, the broker is in a position to deliver the stock. (See secs. 1540 and 586.)

1584. NY Apr. 1943 (1). (a) What prohibition or limitation is there against the repledging by a stockbroker of securities which he has purchased for a customer and is carrying on margin?

(b) Is there any difference between a stockbroker and a dealer in securities?

(c) When a stockbroker is insolvent, what is the situation of a customer as to securities deposited with the stockbroker?

(a) See sec. 1583.

(b) A stockbroker differs from a dealer in securities in that the latter acts as an independent contractor, not as an agent, and therefore owes no fiduciary duty to the customer, except such as may be imposed by statute.

(c) When a stockbroker becomes insolvent and is adjudicated a bankrupt, cash customers who can identify their securities may reclaim them (sec. 1330). All other customers share ratably ahead of general creditors but subject to claims having a higher priority (sec. 1334).

1585. NY Oct. 1939 (7). In order to comply with the Securities Exchange Act of 1934, of what must a broker assure himself before effecting a transaction in a security (a) on a stock exchange, (b) in an over-the-counter market?

(a) The Securities Exchange Act of 1934 provides that no broker, dealer or member may effect a transaction in any security on a national securities exchange (except such exempted securities as government bonds, and so on), unless such security has been duly registered under the act.

(b) The Securities Exchange Act further provides that no broker or dealer may effect an over-the-counter transaction in, or attempt to induce the purchase of any security, unless the broker is registered with the Securities Exchange Commission. This restriction does not apply to brokers and dealers whose business is exclusively intrastate, or to those who deal only in exempted securities, commercial paper, bankers' acceptances,

or commercial bills. Over-the-counter transactions thus regulated relate to the use of the mails or any other channels of interstate commerce; and over-the-counter securities embrace those not dealt in on a registered exchange.

1586. AI Nov. 1938 (8). A woman delivered to her broker a certificate, endorsed in blank, for seventy shares of a corporation's stock, with oral instruction to sell when directed. The broker gave her a written receipt without reservation of power or qualification. The broker placed the shares in various quantities in the names of several nominees to facilitate prompt sale, and accounted to the owner for all dividends. Later, the owner decided not to sell, but requested the return "of her stock certificate," and a new certificate for seventy shares was delivered to her. She seeks to hold the broker responsible for the amount of a drop in market value between the date when the stock was placed in the names of the nominees and the date when the new certificate was delivered to her. Upon what theory does she base her claim, and can she succeed in enforcing it?

Presumably, the theory upon which this claim was based was that the broker, in breaking up the certificate and placing the various groups of shares into nominee holdings, was liable for conversion, that is, the unlawful or adverse use of another's property. If the acts in question constituted conversion, liability for consequent damage would follow.

However, the acts in question did not constitute conversion. Shares of stock are merely uniform units of ownership. One certificate for seventy shares of a given stock evidences exactly the same rights as another certificate for seventy shares of the same stock. The broker was not required to keep or return the identical stock certificate deposited by the customer, so long as he had available at all times and was able to return to the customer a certificate for the same number of shares as that deposited. (See secs. 586 and 1540, subd. (c).)

1587. AI Nov. 1942 (10). Waldron placed an order with a stockholder to purchase some stock on margin, depositing as collateral certificate No. 137 for 200 shares of X Stock and certificate No. 78 for 300 shares of Y Stock, both endorsed in blank. Nothing further was said by the parties and nothing in writing was signed by either of them except a simple order and a simple receipt, neither of which contained any qualifications or conditions whatsoever.

(a) Has the stockbroker the legal right to have these certificates transferred at once to a nominee selected by the stockbroker without Waldron's knowledge or consent?

(b) After some months of profitable trading, during which it was not necessary for the stockbroker to utilize any of the collateral originally deposited, Waldron closes the account, receiving a check for the balance due

him. The stockbroker refuses to return the two stock certificates originally deposited with him but offers to return various certificates aggregating 200 shares of X Stock and various certificates aggregating 300 shares of Y Stock. Is Waldron legally obliged to accept this offer by the stockbroker?

(a) The stockbroker has the right to make the transfer. (See secs. 586, 1586 and 1540, subd. (c).)

(b) Waldron is obliged to accept the offer. (See secs. 586, 1586 and 1540, subd. (c).)

1588. AI and NY Nov. 1944 (12). (a) Arms is trustee of the Jones estate. He appoints Bush his agent to perform his trust duties. Bush fraudulently misappropriates \$1000 of the trust funds. Arms, the trustee, is sued for the amount.

(1) Can Arms, the trustee, delegate his trust duties to Bush, his agent? Explain.

(2) Is Arms liable? Why?

(b) What is an auctioneer?

(c) Whom does an auctioneer represent?

(d) Name some of the implied powers of an auctioneer.

(e) Name *three* limitations to the powers of an auctioneer.

(a) (1) Arms cannot delegate his trust duties to Bush. A trust is a confidence reposed by one person with respect to property held by him for another's benefit. Such confidence or fiduciary relationship, being highly personal in nature, cannot be delegated or bartered away, otherwise the very purpose of the trust might be defeated. A trustee may delegate routine, but not fiduciary duties. (See sec. 1816, subd. (a).)

(2) Arms is liable. Since Arms as trustee would have been liable had he himself been guilty of fraudulent misappropriation, he is no less liable when such misappropriation is committed by an agent to whom Arms had no right to delegate trust duties. (See sec. 1816, subd. (a).)

(b) An auctioneer is a person authorized and licensed to conduct an auction, which is a public sale of property to the highest bidder.

(c) An auctioneer, in making a sale, is primarily the seller's agent. As such, he owes the usual duties of an agent to his principal: loyalty, good faith, obedience to instructions and a proper degree of skill, care and diligence in the discharge of his duties. Once the hammer falls, however, the auctioneer also becomes the purchaser's agent. When he enters a memorandum of the sale in his notebook, he binds the seller on behalf of the purchaser (sec. 589); and when he accepts a deposit, he

is responsible therefor to the buyer if the seller refuses or fails to complete the sale. Both seller and buyer are bound by the auctioneer's announcement as to the identity of the property and the terms and conditions of sale.

(d) Among the implied powers of an auctioneer are the following: (1) the power to determine the point at which the highest bid is deemed reached, (2) the power to close the bidding by accepting the bid, (3) the power to bind the parties by notations in his memorandum book, (4) the power to accept and hold deposits and final payment on the sale for the account of the seller and to the credit of the purchaser.

(e) Three limitations to the powers of an auctioneer are: (1) The auctioneer has no authority to warrant the property he sells; (2) unless otherwise authorized, an auctioneer may accept only cash in payment; (3) an auctioneer may not delegate his power to sell.

1589. AI May 1941 (10). In what type or kind of business is a *del credere* agent commonly found?

Give a brief example or statement of facts illustrating such an agency.

Del credere agencies are commonly found in businesses which employ commission merchants or agents whose relatively independent financial status enables them to guarantee the accounts of their customers upon the usual arrangement for higher commissions. The following statement of facts¹² illustrates a transaction involving a *del credere* factor or commission merchant:

"Between the 1st day of January, 1886, and the 19th day of March, 1890, the firm of John F. Plummer & Co., of the city of New York, were engaged in business as commission-merchants, and on or about the 1st day of January, 1888, that firm entered into an agreement with the Springville Manufacturing Company, whereby the company was to ship and consign goods manufactured by them to said firm, as its factors, for sale for the account of the company; the proceeds of all sales was (*sic*) guarantied by the firm. As compensation for such services, it was agreed that John F. Plummer & Co. should receive a commission of 6 per cent. upon the sales made by the firm, which commission was understood to be made up of 3½ per cent. for selling the goods, and 2½ per cent. for guarantying prompt

¹² From *Springville Manufacturing Co. v. Lincoln*, 16 Daly 318, 11 N.Y. Supp. 75.

payment by the purchasers, and there was to be paid by the company an additional 1 per cent. for all other expenses except freight."

1590. NY Oct. 1935 (8). What is the relation of a commission agent to his principal?

The relation of a commission agent to his principal is the same as that of any agent to his principal, except that a commission agent (more commonly known as a commission merchant, or factor) is entrusted with possession, management and control of merchandise shipped or consigned to him for sale to third parties, whereas this is not necessarily true of other agents. Usually, the commission merchant sells the merchandise in his own name, receives the proceeds, and remits to his principal, after deducting commissions, or "factorage."

1591. AI May 1935 (5). Describe and explain the following terms so as to differentiate them:

- (a) Agent.
- (b) Servant.
- (c) Employee.
- (d) Independent contractor.
- (e) Broker.

(a) An agent is a person who acts for another, known as principal, in dealing with third parties.

(b) A servant is a person in the employ of another and subject to his control as to what work shall be done and the means by which it shall be accomplished.¹³

(c) An employee is a person who works for another person known as an employer.

(The distinction between an agent, a servant and an employee is not easy to draw. In theory, an agent may bind his principal by contract; a servant may not. In practice, employees frequently bind their employers by contract, and the terms *agent* and *employee* are used interchangeably. However, an agent usually has broader authority and responsibility than an ordinary employee.)

(d) See sec. 1557, subd. (a).

(e) A broker is a person engaged to negotiate the sale of real or personal property. (For distinctions between brokers and other agents, see sec. 583.)

¹³ *Black's L.D.*, 3rd ed. 1606.

CHAPTER VII-A

Partnership

1592. AI May 1939 (5). Define partnership and state and explain briefly the more important legal characteristics of one.

The Uniform Partnership Act defines partnership as "an association of two or more persons to carry on as co-owners a business for profit."

The more important legal characteristics of a partnership are:

- (1) Character of association as a group of individuals, rather than as an entity.
- (2) Voluntary character of association.
- (3) Co-ownership.
- (4) Profit objective.
- (5) Mutual agency of partners.
- (6) Mutual liability of partners.

(For further detail in respect to these characteristics, see sec. 618.)

1593. NY Apr. 1938 (2). Define (a) partnership, (b) general partner, (c) limited partner. Explain wherein a partnership differs from a corporation.

(a) See sec. 1592.

(b) The term *general partner* relates to those members of a limited partnership whose powers, authority and liability are not limited as in the case of the limited or special partners, but correspond, rather, to the powers, authority and liability of the members of an ordinary partnership.

(c) A limited partner is a member of a limited partnership, whose powers, authority and liability, in contrast with those of a general partner in the firm, are limited by statute.

An ordinary partnership differs from a corporation in the following respects:

(1) A partnership is an association of individuals as such. It is not, strictly speaking, an "entity," or separate being, al-

though for some purposes partnerships are now treated as such (sec. 657). A corporation, on the other hand, is an entity, separate and apart from the incorporators who form it, the stockholders who own it, the directors who control its general policy, and the officers and employees engaged in the administration of its affairs. A corporation is said to be an "artificial person." (See sec. 722.)

(2) Partners are liable personally for debts of the firm in case firm assets are insufficient to discharge such debts. Stockholders of a business corporation are not liable for the debts of the corporation, except in certain special cases (such as those involving wages, and obligations of stockholders who have not fully paid for their stock).

(3) Each partner is bound by the acts of every other partner within the scope of the firm business. Stockholders cannot bind one another on the theory of agency, or because they happen to be stockholders of the same corporation.

(4) Death, bankruptcy, or the sale of a partner's interest in the firm dissolves the firm, whereas, death, bankruptcy, or the sale of a stockholder's interest in no way affects the corporation.

(5) The formation of a partnership requires no sanction or approval by the state or other governmental authority, whereas business corporations cannot be created except by state approval in the form of a charter.

(6) Partnerships may be engaged in enterprises of a non-trading or professional character, such as the practice of medicine, law or accountancy, whereas business corporations are prohibited from practicing such professions.

1594. NY Apr. 1943 (14). (a) Define partnership.

(b) Name the different classes of partners.

(c) Can one share profits and not be liable for debts?

(d) Can one be liable for debts and not share profits?

(a) See sec. 1592.

(b) Partners may be classified as general, limited (special), secret, silent, dormant and nominal. (See sec. 641-646 for definitions.)

(c) Persons may share profits in a partnership and not be liable for debts in the following cases: (1) when the profits are received, not as such, but (a) in payment of a debt, (b) as interest on a loan, (c) as wages, (d) as rent, (e) as an annuity

on behalf of a deceased partner, or (f) as consideration for the good will of a business; and (2) when they are limited or special partners, in which event their liability for debts is not personal, but extends only to the amount of their capital investment.

(d) One may be liable for the debts of a partnership and yet not share profits therein if he is an ostensible or nominal partner. In such case the law imposes a liability on the ground of estoppel and not because of any real membership in the firm.

1595. NY Oct. 1939 (1). (a) Can a corporation form a partnership with an individual? Explain.

(b) What is the liability of an incoming partner?

(a) A corporation, from its very nature, does not have the power to become a partner (sec. 878). However, so far as third parties are concerned, a corporation may be liable as a partner when it enters into an arrangement that amounts to a partnership and derives the benefits therefrom, in which event the law will refuse to allow the corporation to escape its liabilities. In short, a corporation may become a partner by estoppel.¹

(b) "A person admitted as a partner into an existing partnership is liable for all the obligations of the partnership arising before his admission as though he had been a partner when such obligations were incurred, except that his liability shall be satisfied only out of partnership property."² In other words, the liability of an incoming partner for pre-existing firm debts is not personal, but is limited to the interest of such partner in the assets of the firm. This is because the debts of the old firm are properly chargeable as against the partnership assets, and there ought to be no transfer of such obligation personally to an incoming partner, unless the latter has agreed personally to assume the same.

1596. NY Apr. 1939 (3). (a) What is the real test of partnership?

(b) Can persons become partners without their knowledge?

(c) Define special partner and state his liability.

(d) Define dormant partner and state his liability.

(a) The true test of partnership is the intent of the parties. Such intent may be expressed in an agreement or implied from

¹ *Catskill Bank v. Gray*, 14 Barb. 471, 479; *Post & McCord v. City of New York, et al.*, 86 Misc. 300, 148 N.Y. Supp. 568, 570.

² *Uniform Partnership Act*, sec. 17.

the circumstances. If the partners by word or conduct show that they intended to carry on a business as co-owners for profit, they will be deemed to be partners (see secs. 620 to 629).

(b) Persons can, and often do become partners without their knowledge. If a person so conducts himself as to justify the reasonable inference that he is another person's partner, the law will hold him as such, whether he knows he is undertaking the obligation of partnership or not. This is particularly true in relation to third persons to whom one holds himself out or allows himself to be held out as a partner; or in cases where one so conducts himself that a third person is justified in assuming that a partnership exists.

It is true that persons, as to one another, cannot become partners unless they really intend to become such. It is also true that partnership is defined as a "voluntary association," and the law will not, as a rule, "surprise a person into partnership." Yet if persons "intend to do a thing which in law constitutes a partnership, they are partners, although their purpose was to avoid the creation of such a relation."³

(c) A *limited* or *special* partner is one who does not participate to the full in partnership liability. He is permitted to limit his liability to the amount of his investment, provided such limitation is duly specified in the limited partnership certificate.

(d) A dormant, or "sleeping" partner, is one who is both silent and secret. His liability or liabilities to third parties are the same as those of a general partner, if his connection with the firm is discovered. The fact that he is a dormant partner does not prevent him from asserting himself as an active partner and taking part in managing the firm's business, unless he is prevented from so doing by the partnership agreement.

1597. AI and NY Nov. 1944 (10). (a) An insolvent partnership agreed with creditors that the business should be continued under the supervision of a managing committee designated by the creditors until their claims were fully paid off out of profits. Are the creditors who are parties to this

³ *Evans v. Warner*, 20 App. Div. 230, cited with approval in *Pierce v. Feno*, 184 N.Y. Supp. 851, 856, aff'd 206 App. Div. 649. To the same effect: *McDonnell v. Battle House Co.*, 67 Ala. 90; *Morgan v. Farrel*, 58 Conn. 413, 20 A. 614; *Gray v. Blasingame*, 110 Ga. 343, 35 S.E. 653; *Stanchfield v. Palmer* (Iowa), 4 Greene 23; *New Orleans v. Gauthreaux*, 32 La. Ann. 1126; *Bromley v. Elliot*, 38 N.H. 287; *Wessels v. Weiss*, 166 Pa. 490, 31 A. 247; *Cothran v. Marmaduke*, 60 Tex. 370; *Kellogg v. Griswold*, 12 Vt. 291; *Townley v. Crickenberger*, 64 W.Va. 379, 63 S.E. 320.

agreement liable as partners to the new creditors of the continued business?

(b) The partnership firm of Altman, Berkley & Calvert became bankrupt. Among the claims presented was an unpaid income tax due the United States by a partner, Altman. The tax was based on income he had received from the partnership business. Is the United States entitled to payment out of the firm estate in priority to firm creditors?

(a) The creditors who are parties to this agreement are not liable as partners to the new creditors of the continued business unless the new creditors were unaware of the capacity in which the managing committee functioned and had a right to assume that the persons ostensibly engaged in conducting the business as partners were actually such. Persons who share profits in a business, not as profits but as repayment of a debt, and who conduct the affairs of the partnership, not as partners but for the purpose of protecting their interests as creditors, are not liable as partners unless their conduct is such as to estop them from denying their liability as partners.

(b) The United States is not entitled to payment out of the firm estate in priority to firm creditors. It is one of the partners, Altman, who owes the tax, not the firm. Under the rule of marshaling assets (sec. 708), firm assets must first be made available for payment of firm debts, before individual creditors may have recourse to such assets. The United States, in this case, is an individual, not a firm creditor.

1598. AI May 1942 (3). (a) Is the sharing of gross income from property jointly owned stronger evidence of the existence of a partnership than is the sharing of net income therefrom?

(b) Can a landlord who agrees to accept a share of his tenant's net profit as rent be held to be a partner?

(c) Can one or more, but not all, of the partners make a valid assignment of all the partnership property for the benefit of its creditors, or must all partners join in it?

(a) The sharing of gross income from property jointly owned is not stronger evidence of the existence of a partnership than is the sharing of net income therefrom; rather, the reverse is true. The sharing of gross returns does not of itself establish a partnership. Indeed, the Court has held that it does not even furnish prima facie evidence of a partnership. The sharing of *net returns*, however, does furnish prima facie evidence of a partnership; but no such inference may be drawn if the profits are received for any of the reasons shown in sec. 624.

(b) A landlord who merely agrees to accept a share of his tenant's net profit as rent cannot be held to be a partner on that account alone. Only when he participates in the conduct of the tenant's business or gives other indication of an interest as copartner beyond that of mere profit sharing, can he be held as a partner.

(c) Partners cannot make a valid assignment of all the partnership property for the benefit of creditors unless all partners join in the assignment, since such an act requires unanimous consent of the partners (see sec. 684).

1599. NY Oct. 1941 (12). (a) State, with reasons, whether, in your opinion, the sharing of profits creates a partnership.

(b) Compare joint venture with partnership.

(c) What basis controls the distribution of profits to partners?

(a) The sharing of net profits furnishes *prima facie* evidence of a partnership; that is, in the absence of proof to the contrary it will justify the presumption that a partnership exists. However, no such inference may be drawn if the profits are received (1) in payment of a debt, (2) as interest on a loan, (3) as wages, (4) as rent, (5) as an annuity on behalf of a deceased partner, or (6) as consideration for the good will of a business. (See secs. 625-629.)

(b) In a joint venture, there is merely co-ownership for a given limited purpose, without the usual powers, duties and responsibilities that go with a partnership. In a partnership, persons associate as co-owners for the continued prosecution of an enterprise for profit. (For examples illustrating the distinction, see sec. 636.)

(c) Profits are distributed among partners in accordance with the articles of copartnership. In the absence of agreement on the subject, partners share profits and losses equally, regardless of unequal capital contributions.

1600. NY Oct. 1937 (5); NY Nov. 1932 (3). What reasons may be advanced to support the contention that one who receives a share of the profits of a business firm is not a partner?

See sec. 1599, subd. (a).

1601. AI Nov. 1938 (2). Two men were legally engaged in an unincorporated business under the duly recorded assumed name of The Atlantic Company without any written agreement, and it became necessary to determine whether they were partners. One had invested cash in the business and the other had lent his credit to it and had assisted in the manage-

ment of it. What documents would you examine and for what other facts would you inquire as likely to have significant bearing on the question?

I would examine the following documents and inquire into the following facts:

(1) *Registration certificate.* Since the firm was engaged in business under a duly registered fictitious name, the registration certificate should disclose the full names of all partners (sec. 654).

(2) *Books of account.* The concern's books of account might reflect direct evidence of the relationship of the parties in respect to capital accounts, profit and loss items, and so on. The sharing of net profits furnishes prima facie evidence of a partnership (sec. 624).

(3) *Stationery.* If the stationery bore the name of The Atlantic Company, with the names of both men printed or engraved thereon in such way as to indicate equality of position and interest, such stationery would afford evidence of a partnership.

(4) *Contracts, business orders, invoices, and so on.* An examination of contracts, business orders, invoices, and so on made out and executed during the course of business, might afford evidence of a proprietary interest by both parties, or the contrary. If, for example, contracts were signed in the name of the company by either or both parties indiscriminately, this would constitute evidence of a proprietary interest on the part of both, that is, of a partnership.

(5) *Lease.* On any lease of premises occupied by The Atlantic Company, signature on behalf of such concern by both parties would tend to establish a partnership.

(6) *Deeds, bills of sale, and so on.* If title documents to property owned by the concern, such as deeds to real property, bills of sale and chattel mortgages relating to personal property, and so on are made out in the names of both parties, they constitute some evidence of a partnership.

(7) *Correspondence.* The most direct evidence of the existence or nonexistence of a partnership is frequently furnished by correspondence showing how the parties regarded themselves and their respective interests in the business, in their dealings with third parties. For example, if one of the parties, in a letter, referred to "my partner," or, on the other hand, to

"my employer," such reference would constitute an indication of the relationship between the parties.

(8) *Bank accounts.* The manner in which the concern's bank accounts were handled, who was authorized to sign checks, whether countersignature was required, are all matters which would have a bearing on the existence or nonexistence of a partnership.

(9) *Law suits.* The capacity in which parties bring or defend suits, the judgments rendered on such suits, testimony given, and so on would constitute important documentary evidence on the point. If the parties filed suit in any action as copartners, that would definitely establish the existence of a partnership. If they were sued as partners and found to be such in the judgment rendered, the existence of a partnership could thereby be established. If, in any other action, the parties as witnesses testified to the existence of a partnership, such testimony would be directly in point.

(10) *Contributions to business.* The character of the contributions to the business made by the parties might determine whether such contributions constituted capital, or business loans. If interest is charged on such contributions, or on credit loaned to the firm without other or further return, such fact might tend to negative the existence of a partnership. So would an arrangement whereby the moneys contributed are returnable at a fixed time, or on demand. On the other hand, a contrary arrangement might tend to establish the contributions as in the nature of capital, that is, that the arrangement was a partnership.

(11) *Agency or authority in acting for the firm.* One of the characteristics of a partnership is the mutual agency of its members. If, in their dealings with others, the parties disclosed the broad general authority customary with members of a firm, rather than the limited agency of an employee, such fact would be pertinent evidence on the existence of a partnership. Transactions revealing the nature of such agency might involve (a) debts incurred, (b) assets purchased, and (c) any other basic business arrangements on behalf of the firm.

1602. AI May 1940 (5). (a) Name one or more special types of partnership, as distinguished from an ordinary partnership, and state the principal characteristic of each type named by you.

(b) When a new, or incoming, partner joins an established firm, does the old firm continue or is a new one formed?

(c) Is a new, or incoming, partner liable for debts contracted by the firm prior to the time of his becoming a partner?

(a) Special types of partnership may refer to (1) limited partnerships, (2) joint ventures, and (3) joint stock associations.

(1) The term *special partnership* is most commonly employed to signify a limited partnership, or a partnership which permits certain partners to be silent or inactive and to limit their liability to the respective amounts of their investments.

(2) The term *special partnership* has also been applied to one formed for a single isolated transaction, or for the conduct of a special or single line of business. The object of such an association is not the continuous prosecution of a business for profit, so much as the association of two or more persons for a specific and limited objective. Such an association is more commonly referred to as a joint venture. Examples are: associations formed to buy and sell, for profit, a parcel of land; to ship a cargo to a given destination for profit; to buy and operate a threshing machine; to finance and sell a particular patent; or to buy and sell a given block of securities.

(3) The term *special partnership* has also sometimes been applied to joint stock associations or unincorporated enterprises, resembling partnerships in certain respects and corporations in others (see sec. 637).

(b) The entry of a new or incoming partner into a firm results at law in the establishment of a new firm, since a partnership, unlike a corporation, is an association of persons as such and not, strictly speaking, an entity (see sec. 1593). By the entry of the new member into the firm a new association of persons, that is, a new partnership, results.

(c) A new or incoming partner is liable for all existing firm obligations, but this liability can be satisfied only out of partnership property.⁴ In other words, the liability of an incoming partner for pre-existing firm debts is not personal, but is limited to his interest in the firm's assets.

1603. NY Apr. 1935 (10). Define a limited or special partner. May such a partner make his capital contribution in services? In the distribution of assets on dissolution, do amounts due a special partner for profits or compensation rank with these same items due the general partners or has such a special partner a preference over the general partners?

⁴Uniform Partnership Act, sec. 17.

For a definition of a limited or special partner, see secs. 710 and 1602.

A limited or special partner may not make his capital contribution in services. He must contribute either cash or property.

In the distribution of assets on dissolution, amounts due a special partner for profits or compensation rank ahead of these same items due the general partners. The liabilities of a limited partnership are discharged in the following order:

(a) Those to outside creditors in the order of priority as provided by law.

(b) Those to limited partners in respect to their share of the profits and other compensation by way of income on their contributions.

(c) Those to limited partners in respect to their capital contributions.

(d) Those to general partners other than for capital and profits (advances, loans, and so on).

(e) Those to general partners in respect to profits.

(f) Those to general partners in respect to capital.

1604. AI May 1935 (7). (a) Can a partnership be created in any way other than by express contract? If so, give an example.

(b) List (but do not discuss) the various causes for dissolution of a partnership otherwise than in accordance with provisions of the contract or articles of partnership.

(a) Apart from express contracts, partnerships may be created by (1) implied contracts and (2) estoppel.

(1) Persons may so conduct themselves as to create a partnership by the established standards of legal intent, though actually such persons are unaware that they have entered into a contract of copartnership. (For an example, see sec. 650.)

(2) When a person holds himself out, or permits himself to be held out as a partner, he may be charged with the liability of a partner though in fact no partnership actually exists.

(b) A partnership dissolution may be voluntary or involuntary.

Voluntary dissolution may be brought about not only by the terms of the original agreement or articles of copartnership, but also by subsequent agreement between the parties.

Involuntary dissolution may be brought about (1) automatically by operation of law, as in the case of (a) death, (b) bankruptcy, or (c) illegality, or (2) it may be judicially de-

creed at the instance of a partner or someone standing in his place in any of the following cases: (d) insanity, (e) incapacity, (f) misconduct, (g) futility, or (h) other circumstances which make it equitable to decree a dissolution. (See secs. 693 to 696.)

1605. AI Nov. 1937 (2). If you were consulted by an attorney at law who was about to draw a partnership contract to be executed by three practising public accountants, what provisions would you recommend for inclusion in the contract?

The following provisions might be recommended for inclusion:

- (a) Names and addresses of partners.
- (b) Firm name.
- (c) Nature, purpose and scope of partnership activity.
- (d) Location of principal place of business.
- (e) When partnership is to take effect.
- (f) Duration of partnership.
- (g) Capital contributions of each partner: cash, property or services; if cash, amounts and when payable.
- (h) Interest, if any, payable on capital or other contributions.
- (i) Profits and losses: how shared.
- (j) Profits: how figured.
- (k) Drawing and salary accounts.
- (l) Time to be given to business by each partner.
- (m) Reservation of right, if any, to engage in other business; nature and extent of nonpartnership activities, and limitation thereon, if any.
- (n) Duties of each partner.
- (o) Management and control: distribution of authority among partners.
- (p) Limitations, if any, upon authority of partners, right to bind firm by certifications, and so on.
- (q) Designation of bank and manner of signing or counter-signing checks.
- (r) Books of account, inventories and statements: where to be kept, and equal access thereto by partners.
- (s) Right, if any, of partner to withdraw, conditions therefor, and notice required.
- (t) Dissolution: right to continue business upon withdrawal, death, disqualification or incapacity of any partner,

with provisions as to the adjustment of such partner's interest.

(u) Disposition of firm name in case of dissolution.

(v) Disposition of good will in the event of dissolution.

(w) Administration of partnership property and affairs upon dissolution: partner or partners to conduct same.

(x) Disposition of firm's working papers; arrangements, if any, with clients, and so on.

(y) Provision for arbitration, if any, in case of dispute among partners.

1606. NY Oct. 1942 (13). Ames, Ball and Carr, individual merchants, decided to merge their businesses as general partners and to accept Gates as a special partner, all on January 1, 1941. Their contributions to the firm were as follows:

Ames: cash \$2000, other net assets \$8000

Ball: cash \$1000, other assets \$11,000, less debts \$2000

Carr: cash \$3000, other net assets \$4000 and his services

Gates: cash \$13,000

At December 31, 1941, before any payments to partners, except to Carr for services, the firm had cash \$12,000, other assets \$48,000 and debts \$10,000.

(a) What was the amount of the partnership capital?

(b) What was the amount of the partnership property?

(a) The amount of the partnership capital was \$40,000, consisting of \$10,000 contributed by Ames, \$10,000 (net) by Ball, \$7000 by Carr, and \$13,000 by Gates.

(b) The amount of the partnership property was \$60,000 consisting of \$12,000 cash and \$48,000 in other assets.

1607. NY Oct. 1943 (2). Two partnerships are formed, one by *A* and *B*, the other by *X* and *Y*, each agreement providing that the partnership is to continue for one year and the profits and losses are to be divided equally. In the first, *A* and *B* each agree to contribute \$2500 for capital. Each does this, but at the same time *A* also advances \$2500 more. In the second, *X* and *Y* each agree to contribute \$5000 for capital. *X* does this but *Y* pays in only \$2500 and no more during the year. Each partnership, therefore, begins with cash in the amount of \$7500 paid in by the partners and these amounts stand unchanged for the year. At the end of the year, each partnership has made a profit of \$4000.

(a) What difference, if any, is there between the two firms, except as to the persons who are partners in them?

(b) Should each of the four partners receive \$2000 for his share of the profits or should some other distribution be made?

(a) The two firms differ as to their respective capital contributions and as to partnership advances.

In the firm of *A* and *B* the total capital contribution is

\$5000; in the firm of *X* and *Y*, \$10,000. The total amounts of cash received by both firms are the same; this is because the capital contributions in the firm of *A* and *B* have been fully paid and an additional sum of \$2500 has been advanced by one of the partners, whereas in the firm of *X* and *Y* only 75% of the capital has been paid in, which equals in amount the total capital contributions plus the advances in the firm of *A* and *B*.

(b) Each of the four partners is not entitled to receive \$2000 for his share of the profits. The distribution rights of the partners in respect to the \$4000 profit made by each firm will differ. *A* is entitled to the return of his \$2500 advance before profits can be distributed; that is, *A* is entitled to \$2500 plus \$750 (one half of \$1500), or \$3250. *B* is entitled to one half of \$1500, or \$750.

X and *Y* are each entitled to \$2000; but since *Y* owes \$2500 on account of his share of the capital contribution, such amount may be debited against his \$2000 interest in the profits; that is, his account will be debited in the amount of \$500.

1608. AI Nov. 1941 (6). (a) The partnership of *A* and *B* has no assets except real property. Is *A*'s proprietary interest in the firm, as a partner, real or personal property?

(b) On May 2, 1941, the three partners in the firm of *A*, *B*, & *C* signed a dissolution agreement whereby the firm's affairs were to be liquidated as of the following June 30th. On May 15th, *B* without the knowledge or consent of *A* or *C* procured for himself a five-year lease of the premises occupied by the firm to run from the following July 1st, and on July 1st *B* sold this lease at a profit. Have *A* and *C* a legal right to share in *B*'s profit?

(a) A partner's interest in the firm itself, as distinguished from his interest in specific property owned by the firm, is the partner's share of the profits and surplus; that is, it is an interest in everything that the firm owns and earns, subject to the claims of creditors. Such interest is personal property, though the firm as such owns nothing but real property.

In addition to a partner's interest in the firm itself, each partner is co-owner with his copartners of specific partnership property, which he holds as a "tenant in partnership," corresponding to a tenancy in common held by co-owners in a joint venture. Such interest is real, not personal. (See secs. 663 and 664.)

(b) *A* and *C* have a legal right to share in *B*'s profit. The relationship between partners is fiduciary. A partner must

account to his copartners for any personal profit or advantage earned out of his partnership connection. No partner may take unfair advantage of his copartners. (See sec. 666.) "Authority is, of course, abundant that one partner may not appropriate to his own use a renewal of a lease, though its term is to begin at the expiration of the partnership. *Mitchell v. Read*, 61 N.Y. 123, 19 Am. Rep. 252; *Id.*, 84 N.Y. 556. The lease at hand with its many changes is not strictly a renewal. Even so, the standard of loyalty for those in trust relations is without the fixed divisions of a graduated scale. . . . Here the subject matter of the new lease was an extension and enlargement of the subject matter of the old one. A managing coadventurer appropriating the benefit of such a lease without warning to his partner might fairly expect to be reproached with conduct that was underhand, or lacking, to say the least, in reasonable candor, if the partner were to surprise him in the act of signing the new instrument. Conduct subject to that reproach does not receive from equity a healing benediction."⁵

1609. AI May 1936 (4). Hawkes and Andrews were public accountants practising under the firm name of Hawkes and Andrews. Without the knowledge of Hawkes, Andrews borrowed money on a promissory note signed and endorsed by him individually and then endorsed by him with the firm name. He used the money thus borrowed for regular and ordinary expenses of the firm. In an action on the note, by the payee, can judgment be obtained against Hawkes?

The payee cannot obtain judgment against Hawkes. This being a nontrading firm, Andrews had no implied right to borrow money for the firm. As to the payee, therefore, the firm is not liable. Andrews, however, who signed the note personally, would be personally liable on it; but since the moneys were used for firm purposes, Hawkes is liable to Andrews for his share of the proceeds of the loan.

1610. AI-NY Nov. 1945 (8). (a) Abel, of the firm of Abel, Brewer and Colt, makes a contract with Dane for partnership purposes. Abel is guilty of fraud in the making of the contract. Brewer and Colt are entirely ignorant of the matter. Dane sues Abel, Brewer and Colt. Is the firm liable? Explain.

(b) Arrow was admitted into the firm of Byrns and Co. on January 1, 1944. At that time the firm was indebted to several creditors, including Conick. The firm thereafter became insolvent, and, the assets of the partnership and the other partners being insufficient to pay the partnership

⁵ *Meinhard v. Salmon*, 249 N.Y. 458, 466, 468.

debts, Conick sought to hold Arrow personally liable for the deficit in his claim. Could Conick do so? Why?

(c) By a written agreement between the copartnership Yates and Zachary, and Daniels, their employee, Daniels was to receive for his services to Yates and Zachary a certain percentage of the profits of the business. Does Daniels thereby become a partner as to (1) Yates and Zachary, or (2) as to third persons? Explain.

(d) Which, if any, of the following acts may be performed by a partner or any number of partners (less than all in a going partnership business) without the consent or authority of all the partners?

(1) Assign the property of the partnership for the benefit of creditors.

(2) Dispose of the good will of the partnership.

(3) Do any act which would make it impossible to carry on the ordinary business of the partnership.

(4) Confess a judgment.

(5) Submit a partnership claim or liability to arbitration or reference.

(a) The firm is liable. Partners are liable for one another's torts committed during the course of partnership activity (sec. 685). The ignorance or nonacquiescence of the unoffending partners is immaterial.

(b) Conick cannot hold Arrow. The liability of an incoming partner for existing firm debts can be satisfied only out of partnership property. (See secs. 688 and 1595, subd. (b).)

(c) (1) Daniels, by accepting a percentage of the profits for his services, does not thereby become a partner (sec. 627).

(2) Unless Daniels so conducts himself as to lead third persons reasonably to believe that he is a partner, and to rely thereon, he cannot be charged by such persons with the liability of a partner.

(d) None of the acts listed will be binding upon the firm unless done by unanimous consent of the partners (sec. 684).

1611. NY Apr. 1936 (4). How may a retiring partner terminate his liability for the debts of the partnership so that such liability shall attach to no new obligations? How may he escape from his liabilities for existing obligations?

A retiring partner may terminate his liability for the debts of the partnership so that such liability shall attach to no new obligations:

(1) By giving *actual notice* of his retirement to all parties who had extended credit to the partnership prior to dissolution and had no knowledge or notice of the dissolution;

(2) By giving *constructive notice* to all other parties (that is, by advertising the notice in a newspaper of general circula-

tion in the place or places where the partnership business was being conducted);

except that parties who have knowledge of the retirement cannot complain of a failure to inform them of what they already know; neither is it necessary for a secret partner to give notice of his retirement, because third parties who are unaware of his connection with the firm, are in no way injured by not being informed that such connection has been severed.

The Uniform Partnership Act⁶ provides that after dissolution, a partner can bind the firm only by acts appropriate for winding up partnership affairs or completing transactions unfinished at dissolution, except that partners may be bound by any transaction, if the other party to the transaction (1) had extended credit to the partnership prior to dissolution, and had no knowledge or notice of the dissolution, or (2) though he had not so extended credit, had nevertheless known of the partnership prior to dissolution, but had no knowledge or notice of the dissolution, and the fact of dissolution had not been advertised in a newspaper of general circulation in the place or places where the partnership business was regularly conducted.

A partner may escape from his liability for existing obligations only with the consent of firm creditors. Partners may agree among one another that a retiring partner is to be freed of existing firm debts; but while such agreement among partners is binding upon themselves, it cannot bind creditors who have not been consulted and whose consent to such arrangement has not been obtained. To effect a novation of liability (sec. 212) as to creditors and a discharge of any particular partner as to them, requires the acquiescence of the creditors. Such acquiescence may be express, or it may be implied from certain circumstances. For example, the Uniform Partnership Act⁷ provides:

(1) The dissolution of the partnership does not of itself discharge the existing liability of any partner.

(2) A partner is discharged from any existing liability upon dissolution of the partnership by an agreement to that effect between himself, the partnership creditor and the person or

⁶ Sec. 35.

⁷ Sec. 36.

partnership continuing the business; and such agreement may be inferred from the course of dealing between the creditor having knowledge of the dissolution and the person or partnership continuing the business.

(3) When a person agrees to assume the existing obligations of a dissolved partnership, the partners whose obligations have been assumed shall be discharged from any liability to any creditor of the partnership who, knowing of the agreement, consents to a material alteration in the nature or time of payment of such obligations.

1612. NY Oct. 1935 (9). In connection with debts of a partnership, what are the liabilities of (a) a new partner, (b) a retiring partner?

(a) See sec. 1595, subd. (b).

(b) See sec. 1611.

1613. NY Oct. 1936 (3). List *five* events that will effect a dissolution of a partnership.

See sec. 1604, subd. (b).

1614. AI-NY May 1945 (8). (a) Altman, Bowers and Cohen were partners in a firm selling merchandise. Cohen, personally, was adjudicated a bankrupt. What effect, if any, had this adjudication on the partnership?

(b) Ajax leased a farm to Billups and agreed to furnish Billups everything necessary to stock the farm. Billups agreed to cultivate the farm and furnish all the labor for one year, at the end of which Ajax and Billups were to divide the crop. Billups hired Cranstoun to aid him in carrying out the work at the farm. Cranstoun was not paid by Billups. Cranstoun sues Ajax for the value of his services, claiming Ajax and Billups were partners. Can he recover? Why?

(c) On the death of a partner, what are the rights of the personal representative of a deceased partner in the affairs of the partnership?

(d) The copartnership articles of Alden and Bruer stipulated that Alden should furnish all the capital and that Bruer should manage the business but without any liability for firm debts. Connors, knowing of these provisions, sold goods on credit to the firm.

(1) Who is liable, Alden, Bruer, or both Alden and Bruer?

(2) What would your answer be if the copartnership articles further stipulated that Bruer was a limited partner?

(a) The adjudication dissolved the partnership. Unless a partnership agreement provides to the contrary, the bankruptcy of a partner automatically dissolves the firm.

(b) Cranstoun may recover from Billups, but not from Ajax. The arrangement between Ajax and Billups was obviously that of landlord and tenant respectively, and the shar-

ing of profits as rent did not make Ajax liable as a partner of Billups. It does not appear that the circumstances indicated such a holding out by Ajax in respect to Cranstoun and other third parties as would constitute Ajax a partner by estoppel.

(c) On the death of a partner his personal representative (sec. 1177) stands in his place. The executor or administrator of a deceased partner's estate has merely the right to require that the surviving partner or partners wind up the affairs of the firm within a reasonable time and pay over to the estate the deceased partner's share of firm assets and profits after payment of firm debts.

(d) (1) Both Alden and Bruer are liable. An agreement for limitation in liability on the part of one or more partners is ineffective except upon compliance with the provisions governing limited partnerships, including the filing, recording and publishing of a limited partnership certificate. (See sec. 711.) The parties do not appear to have intended a limited partnership, nor to have complied with the provisions in relation thereto.

(2) Even if the copartnership articles stipulated that Bruer was a limited partner, and even if full compliance were had with the requirements for the formation of a limited partnership, it appears that Bruer managed the business. This would make him a general partner, and liable, in consequence, as such. (See sec. 719.)

1615. AI Nov. 1936 (10). Holland, Jones, and Kerr were partners doing business as note brokers under the name of Holland & Co. The partnership was duly dissolved May 1, 1936, Kerr being named as liquidating partner. On May 20, 1936, Kerr procured and sold to Martin a note purporting to be made by the Acme Corporation and dated May 19, 1936. This transaction was conducted in the name of Holland & Co. and Martin, who had no actual knowledge that that partnership had been dissolved, gave Kerr a check to the order of Holland & Co. in payment of the purchase price and accepted from Kerr a guaranty of the signature on the note signed "Holland & Co." Kerr endorsed the check in the name of Holland & Co. and deposited it in his own bank account. The Acme Corporation note proved to be a forgery. Against whom has Martin any rights?

Martin may proceed against Kerr personally or against his own bank on the forged indorsement of the check (sec. 334, subd. (A)).

When a liquidating partner conducts new business not necessary or incidental to winding up the affairs of the firm, he

only, and not firm assets, will be charged thereby, except as to persons without knowledge or notice of the dissolution. Since the partnership was "duly" dissolved, the presumption is that Martin, either as a person who previously extended credit to the firm, or as one who knew of its existence, was duly advised of the dissolution (see sec. 1611). If Martin did not receive notice of dissolution such as he was entitled to under the statute, he had a right to assume the continued existence of the firm Holland & Co. and the continued authority of Kerr to act for the firm; in which event he could hold the firm on its guaranty of the signature on the note, since a partnership guaranty is within the implied powers of a partner if it is ostensibly in furtherance of the partnership business (sec. 682).

1616. NY Apr. 1941 (13). Under dissolution of the partnership, owing to the death of a partner, is the survivor, in the absence of an expressed agreement, entitled to continue the business or must he account for the goodwill and other assets to the representative of the deceased partner?

A surviving partner in winding up the affairs of the firm is chargeable as a trustee in respect to firm assets. In the absence of an express agreement he is not entitled to continue the business except for the purpose of winding up its affairs; and he must account for the good will and other assets to the representative of the deceased partner.⁸

1617. AI May 1935 (4). One joint adventurer began an action at law against his coadventurer for money damages for alleged preventable losses sustained in the joint venture. Many items of debit and credit were in dispute between them. Was the action properly brought? If not, what remedy should the plaintiff have sought?

Suits between joint adventurers may ordinarily be brought at law, especially where profits are ascertained, or the suit is for breach of contract in refusing to recognize a joint adventurer's interest (sec. 701). But where suit is brought for damages for alleged preventable losses sustained in a joint adventure, involving many items of disputed debit and credit, there can be no recovery until the transaction has been closed and a balance struck; hence the remedy would lie in equity by an action for an accounting.

1618. NY Apr. 1940 (1). Answer the following with reference to the dissolution of a general partnership:

(a) State the order in which the assets should be distributed.

⁸ *Slater v. Slater*, 175 N.Y. 143.

(b) Is a partner who has not contributed to the capital liable for a share of any losses sustained by the firm?

(c) Is there any variation in the order of distribution if the firm was a limited partnership with one or more special partners?

(a) In the dissolution of a general partnership, assets should be distributed in the following order:

(1) To creditors other than partners.

(2) To partners for liabilities other than for capital and profits (such as loans, advances, and so on).

(3) To partners for liabilities in respect to capital.

(4) To partners for liabilities in respect to profits.

(b) A partner must share losses sustained by the firm, notwithstanding that he has not contributed to the capital. In the absence of agreement to the contrary, partners share profits and losses equally regardless of unequal capital contributions.

(c) The order of distribution where the firm is a limited partnership, with one or more special partners, presents substantial variation from that which controls distribution in the case of a general partnership. See sec. 1603.

1619. **AI May 1944 (6).** (a) On dissolution of a partnership, in what order are partnership obligations to creditors and partners to be discharged, in the absence of any provision on the subject in the partnership agreement?

(b) *A, B, and C* are partners. Capital contributions—*A*, \$10,000; *B*, \$5000; and *C*, \$5000. Profit and loss to be shared in proportion to capital contribution, that is *A*, 50%; *B*, 25%; and *C*, 25%. After operating the business *A* made an advance of \$5000. Thereafter they decide to liquidate.

The firm has assets at book value of \$60,000 on which they realized \$50,000 on liquidation; liabilities to creditors, \$20,000.

What is the order of discharge of partnership obligations and what amounts are payable in final settlement to the creditors and partners?

(a) See sec. 1618.

(b) The order of discharge of partnership obligations and the amounts payable in final settlement to the creditors and partners are indicated in the following tabulation:

Assets on liquidation.....	\$50,000
(1) Payments to creditors.....	20,000
<hr/>	
Assets available for repayment of advance, re- turn of capital and distribution of net profits	\$30,000
Distribution:	
(2) To <i>A</i> , in repayment of advance.....	5,000
<hr/>	
	\$25,000

(3) Repayment of capital:

To A.....	\$10,000	
To B.....	5,000	
To C.....	5,000.....	20,000
		<hr/>
		\$ 5,000

Profits to be distributed:

To A (50%).....	\$ 2,500	
To B (25%).....	1,250	
To C (25%).....	1,250.....	\$ 5,000
		<hr/>

1620. AI Nov. 1939 (4). *X* and *Y* were partners under a valid partnership agreement which recited the capital contribution of each and provided for the equal division of all profits but made no mention of losses or of the details of settlement upon dissolution. They decided to dissolve and they signed a valid dissolution agreement which provided that the firm's accounts receivable, after collection, were to be divided one third to *X* and two thirds to *Y* until such distribution had reimbursed each partner in full for the balance of his capital contribution; thereafter, any further collections were to be divided equally. This agreement made no mention of losses. It was soon discovered that collectible accounts would be insufficient by \$12,000 to reimburse both partners for their combined capital balances. *X* claimed that only one third of this loss should be charged to him. Is this claim by *X* legally valid?

X's claim is valid.

The dissolution agreement provided that the firm's accounts receivable, after collection, were to be divided one third to *X* and two thirds to *Y* until such distribution "had reimbursed each partner in full for the balance of his capital contribution." Since the accounts receivable could never reimburse each partner in full for the balance of his capital contribution (the same being insufficient for this purpose by \$12,000), the ratio of apportionment must remain at one third to *X* and two thirds to *Y*; that is, the loss, reflecting the failure to obtain repayment of the respective capital contributions of *X* and *Y*, must be shared in the ratio of one third and two thirds, respectively.

Were it not for the modification agreement, the rule of distribution would have been different. In the absence of agreement to the contrary, partners share profits and losses equally, regardless of unequal capital contributions. Thus, but for the modification agreement, the \$12,000 loss would have been shared equally by *X* and *Y*, and each partner's equal share of the loss would have been charged against his claim for repayment of capital.

Suppose, for example, that *X* had contributed \$5000 as capital, and *Y* \$10,000; and that accounts receivable, the sole re-

maining asset, netted \$3000. The corresponding loss (\$15,000 less \$3000) would be \$12,000. The apportionment would be as follows (see sec. 800):

<u>Partner</u>	<u>Capital</u>	<u>Sh. of Loss</u>	<u>Net to Partner</u>
X.....	\$ 5,000	\$ 6,000	\$-1,000
Y.....	10,000	6,000	+4,000
Total.....	\$15,000	\$12,000	\$ 3,000

That is, firm assets (\$3000 realized on accounts receivable, plus the firm's claim against X for \$1000) would have gone to pay Y's claim against the firm for \$4000.

1621. AI May 1937 (3). In the dissolution of an insolvent partnership of three partners, two of whom are insolvent and one solvent:

(a) State the relative rights of creditors who have extended credit to the partnership and of creditors who have extended credit to partners individually, with respect to partnership assets and to assets owned by the individual partners, and

(b) State the basis upon which each partner's account with each of the other partners will be settled on the assumptions that the partnership contract did not specify how profits were to be divided and made no mention of losses, and that throughout the existence of the partnership the capital of the solvent partner had been $\frac{1}{6}$ of the total and the remaining capital had been contributed $\frac{2}{5}$ and $\frac{3}{5}$, respectively, by the insolvent partners.

(a) The relative rights of creditors who have extended credit to the partnership, and of creditors who have extended credit to partners individually, with respect to (1) partnership assets and (2) assets owned by the individual partners are governed by the rule of marshaling assets (sec. 708). Firm assets must first be made available for payment of firm debts, and the partners' individual assets for the payment of their individual debts. If, after payment of firm debts, a surplus remains, such surplus—in which each individual partner has an undivided interest—may be applied to the payment of the partners' individual debts. If, after a partner pays his personal debts out of his personal assets, a surplus remains, such surplus may be applied to the payment of firm debts, provided firm assets are insufficient for this purpose.

(b) Since the partnership contract did not specify how profits were to be divided, they would have been divided equally, had there been any; and since no mention is made of losses, they must be shared equally. Thus, each partner's share of the losses, had each been solvent, would have been one third,

regardless of unequal capital contributions. However, since only one partner is solvent, he bears the entire loss in respect to outside creditors.

In respect to capital losses, and assuming that the insolvent partners have not been adjudicated in bankruptcy (sec. 1281), the partners would be entitled to adjustments on the basis of their respective capital contributions. Thus, suppose that total capital contributions amounted to \$60,000; firm assets upon dissolution, none; liabilities to creditors, \$30,000; total loss, including capital contributions, \$90,000. The solvent partner would pay the debts due outside creditors. The adjustment would then be as follows:

Partner	Capital	Sh. of Loss	Paid to Creditors	Net Due Partner
Insolvent.....	\$20,000	\$30,000	\$ 0	\$-10,000
Insolvent.....	30,000	30,000	0	0
Solvent.....	10,000	30,000	30,000	+10,000
Total.....	\$60,000	\$90,000	\$30,000	—

Upon the basis of the foregoing adjustment, the first insolvent partner owes \$10,000 to the firm and the firm owes him nothing; the second insolvent partner owes nothing to the firm and the firm owes him nothing; and the solvent partner owes nothing to the firm, but the firm owes him \$10,000 (the amount of its claim against the first insolvent partner, which the solvent partner may realize if and when the first insolvent partner regains solvency).

1622. **AI Nov. 1943 (11).** In a partnership composed of *A, B, C*, and *D*, *D*'s interest was purchased by the remaining partners, who gave in payment a note signed by *A, B*, and *C*. Later *C* retired, and his interest was purchased by *A* and *B*, who continued the business. On *A* and *B*'s becoming bankrupt, can *D* prove his unpaid note, given for the value of his interest against the firm estate, as a firm creditor?

D cannot prove his unpaid note as a firm creditor. The note was not signed on behalf of the firm or given as a firm obligation, but was signed by *A, B* and *C*. *D*'s interest was not purchased by the firm but by the remaining partners. "The notes under consideration in this case were the notes of Stephen P. Hallock, one member of the firm, indorsed by Roscoe C. Hallock, the other member of the firm. As between themselves, it was an individual indebtedness of Stephen P. Hallock; Roscoe standing simply as surety. As between themselves and the bank, it was a joint and several obligation, and not a partnership indebtedness or obligation, . . . The bank could

have demanded the firm obligation had they chosen to do so, but, having accepted the joint and several obligation of the members of the firm instead of the firm obligation, they must be held to such election.”⁹

1623. AI Nov. 1937 (8). In the event of one or more but not all the members of a partnership being adjudged bankrupt, can the partnership property be administered in bankruptcy? If not, how will it be administered?

“In the event of one or more but not all of the general partners of a partnership being adjudged bankrupt, the partnership property shall not be administered in bankruptcy, unless by consent of the general partner or partners not adjudged bankrupt; but such general partner or partners not adjudged bankrupt shall settle the partnership business as expeditiously as its nature will permit and account for the interest of the general partner or partners adjudged bankrupt.”¹⁰

1624. AI May 1943 (7). Define limited partnership and state the object to be accomplished by one.

Is a limited partnership recognized by common law or is it created by a statute?

(a) A limited partnership is one permitting certain partners to be silent, or inactive, and to limit their liability to the respective amounts of their investments. The object of such an arrangement is to permit investment by partners who are unwilling to assume the risk of personal liability beyond loss of the investment itself.

(b) Limited partnerships were not recognized at common law. They are formed pursuant to special statute.

1625. NY Apr. 1942 (5). The capital contributed by *X*, a special partner, was \$50,000. The capital contributed by *A* and *B*, general partners, also was \$50,000, of which *A* had paid in three fifths and *B* had paid in two fifths. The agreement provided that each should receive 6% per annum on his capital and that profits, after interest, should be divided 40% to *A* and 60% to *B*. At December 31, 1941, after crediting interest, the books showed:

The capital account of each partner at the original amount	
The personal account of <i>X</i> with a credit balance of.....	\$ 3,000
The personal account of <i>A</i> with a credit balance of.....	1,500
The personal account of <i>B</i> with a debit balance of.....	4,500
The debts owed by the firm to outside creditors, total.....	10,000
The assets, all considered good, amounting to.....	•130,000

The partners decided to dissolve the partnership as of that date.

⁹ *In re Hallock, et al.*, 47 Misc. 571, 96 N.Y. Supp. 105, 112.

¹⁰ *National Bankruptcy Act*, sec. 5 (i).

State textually how the assets should be distributed. An unexplained arithmetic solution will not be a satisfactory answer.

This being a limited partnership, assets must be distributed in the following order (sec. 720):

- (1) To outside creditors.
- (2) To limited partners, in respect to profits or income.
- (3) To limited partners, in respect to capital.
- (4) To general partners, other than for capital or profits.
- (5) To general partners, in respect to profits.
- (6) To general partners, in respect to capital.

To determine profits after interest, to be shared by *A* and *B*, we take the following items of debit and credit:

<u>Debits</u>		<u>Credits</u>	
Total assets.....	\$130,000	Outside creditors.....	\$ 10,000
<i>B</i> 's personal account.....	4,500	<i>X</i> 's personal account.....	3,000
		<i>A</i> 's personal account.....	1,500
		Capital account:	
		<i>X</i>	50,000
		<i>A</i>	30,000
		<i>B</i>	20,000
		<i>Profit</i>	20,000
Total debits.....	<u>\$134,500</u>	Total credits.....	<u>\$134,500</u>

Following the order prescribed by statute, the distribution would then be as follows:

Assets to be distributed.....			\$130,000
Distribution:			
(1) To outside creditors.....		\$10,000	
(2) To <i>X</i> , limited partner's profit by way of interest....		3,000	
(3) To <i>X</i> , capital.....		50,000	
(4) To <i>A</i> and <i>B</i> , general partners, other than for capital or profits.....		0	
(5) To <i>A</i> , general partner, in respect to profits:			
40% of \$20,000.....	\$ 8,000		
Credit balance (presumably unpaid interest).....	1,500	9,500	
To <i>B</i> , general partner, in respect to profits:			
60% of \$20,000.....	\$12,000		
Less, debit balance.....	4,500	7,500	
(6) To general partners in respect to capital:			
<i>A</i>	\$30,000		
<i>B</i>	20,000	50,000	\$130,000

CHAPTER VIII-A

Corporations

1626. AI May 1937 (5). Describe briefly the corporate structure or form of organization by which a corporation conducts its business, specifying the relationships among stockholders, directors, and officers, how a person becomes a stockholder, director, or officer, what documents prescribe the powers of the corporation and the conduct of its affairs and how such documents originate.

A corporation is a fictitious person adopted as a device whereby groups of individuals, large or small, may concentrate their efforts. Being an artificial person, it can act only through human agency: Directors, who are elected by owners or shareholders and who guide the policies and elect the officers of the corporation. The officers administer the corporate affairs with the aid of agents and employees hired by them. Although the stockholders have the ultimate power, in that they elect the directors who elect the officers, they have no executive or administrative authority as such. Likewise, although the directors have general control of policy and general authority over the officers, they have no executive or administrative authority nor any right to interfere with the administrative duties of the officers.

The powers of the corporation are prescribed in its certificate of incorporation or charter, subject to basic statutory provisions governing corporations. The conduct of a corporation's affairs is governed by the by-laws. The charter or certificate of incorporation is executed by the incorporators (secs. 755-765). The by-laws are formulated and adopted by the directors with or without stockholders' approval and in some instances are adopted directly by the stockholders themselves.

A person may become a stockholder in three ways: (1) by original issue, (2) by purchase of treasury stock, and (3) by stock transfer from an existing stockholder.

1627. AI May 1944 (5). (a) The *B* corporation had a credit balance of \$2000 in its check deposit account in the *C* bank. *A*, the sole stock-

holder of *B* corporation, owed the *C* bank \$1800 on a personal note. The *C* bank failed and is in receivership. *A* wishes to set off the claim of the *B* corporation against the bank's claim on the note owed by *A*.

(1) Should the set-off or counter-claim be permitted?

(2) Explain.

(b) *A*, the president of the *B* corporation, indorsed checks payable to the corporation and deposited them in his personal account in the *C* bank. The bank collected the proceeds and paid them out on the personal checks of *A*. The *B* corporation sues the *C* bank for the proceeds of the checks deposited by *A*, its president.

Can the corporation recover? From whom? Is the bank liable? Explain.

(a) (1) The set-off or counterclaim should not be permitted.

(2) The *B* Corporation's credit balance belongs to the corporation, not to *A*, its stockholder. (See sec. 725.)

(b) The corporation can recover from the bank. The bank was chargeable with knowledge that the checks were payable to the corporation and not to *C*. Even if the bank's participation were not deliberate, the bank would be liable in such case for negligence. (See sec. 887.)

1628. NY Oct. 1936 (4). By what authority are corporations created? List three advantages of the corporate form of business organization.

The sovereign power to grant corporate charters is vested in the states. However, the Federal Government may grant corporate charters in territories under its administrative jurisdiction, such as the District of Columbia, and also as an incident to the conduct of its own business and as a means of executing Federal powers conferred by the Constitution. (See sec. 746.)

Six advantages of the corporate form of business organization are: (1) Limitation of liability in respect to debts, (2) limitation of liability in respect to agency, (3) flexibility of financing, (4) continuity of business, (5) transferability of interest and (6) concentration of business strength through right to act as entity. (See sec. 728.)

1629. AI Nov. 1940 (2). A sole proprietor, owning and operating a small retail business, is considering whether he should incorporate his business. List and explain briefly any disadvantages that would ensue from such incorporation.

Among the disadvantages of the corporate form of doing business that would have to be considered are the following:

(1) Expense, (2) taxation, (3) charter limitations upon scope

of activities, (4) limitations upon right to do business in other states and (5) government supervision. (See sec. 729.)

1630. NY Apr. 1944 (9). (a) What is a municipal corporation?

(b) By whom and how is a municipal corporation created?

(c) For what purposes may a municipal corporation be organized?

(a) A municipal corporation is a public corporation created for local governmental purposes. (See secs. 732-733.)

(b) A municipal corporation is created by an act of the legislature. Such act may be a special act granting a special charter or it may be a general statute pursuant to which communities may, by complying with such act, become incorporated and obtain the right to function as a municipal corporation.

(c) A municipal corporation may be organized only for local governmental purposes. (For the various types of municipal corporations, see sec. 733.)

1631. NY Apr. 1940 (12). (a) What is a municipal corporation?

(b) How may a municipal corporation be formed?

(c) Is a municipal corporation a stock or nonstock entity?

(d) How does a municipal corporation act or function?

(a) See sec. 1630, subd. (a).

(b) See sec. 1630, subd. (b).

(c) Under the common law, a municipal corporation would be classed as a nonstock entity, since it does not issue shares of stock. The statutory definition in New York, however (this being a New York question), is that a nonstock corporation "shall be either, 1. A religious corporation, 2. A membership corporation, or 3. Any corporation other than a stock corporation or a public corporation."¹

(d) Municipal corporations, unlike other corporations, function through publicly elected officers instead of through directors elected by shareholders and officers elected by directors.

1632. NY Oct. 1938 (10). (a) What is a municipal corporation?

(b) How is it formed?

(c) What is a municipal charter?

(d) Is the municipal charter a contract between the state and the corporation?

(a) See sec. 1630, subd. (a).

(b) See sec. 1630, subd. (b).

¹ General Corporation Law, sec. 2.

(c) (This being a New York question, we shall base the answer primarily on the New York statute. However, the law governing municipal charters is substantially uniform throughout the country.)

A municipal charter consists either of a special legislative grant of authority to a city of wide corporate powers (for example, New York City), including not only governmental powers but also powers to own real and personal property, to conduct various enterprises of a quasi-business nature, and so on. Where a community is incorporated under a general law, as in the case of incorporated villages, a charter consists in a general grant of corporate authority, upon compliance with the law, and the prescribed procedure. Such general grant is contained in sec. 1-a of the Village Law, which gives an incorporated village certain corporate powers including the power to take, purchase, hold, lease, sell and convey such real and personal property as the purposes of the corporation may require; to take by gift, grant, bequest and devise and hold real and personal property absolutely or in trust for any public use including that of education, art, ornament, health, charity or amusement, for parks or gardens, or for the use or erection of statues, monuments, buildings or structures, upon such terms or conditions as may be prescribed by the grantor or donor and accepted by said corporation and to provide for the proper administration of the same; to make, have and use, and from time to time alter, a common seal; to contract and be contracted with, to sue and be sued, to complain and defend and to institute, prosecute, maintain and defend any action or proceeding in any court or tribunal; to have and exercise all the rights, privileges and jurisdictions essential to a proper exercise of its corporate function, including all that may be necessarily incident to, or may be fairly implied from, the powers specifically conferred upon such corporation; and to have and exercise all the rights, privileges, functions and powers prescribed and exercised by it under existing or subsequent laws.

(d) "A municipal charter is not a contract, either between the municipal corporation and the state, or the corporation and its members or inhabitants. Hence, it is not within the protection afforded by constitutional provisions prohibiting the passage of laws impairing the obligation of contracts." ²

²43 *Corpus Juris*, 84, citing numerous cases in various jurisdictions.

1633. NY Apr. 1939 (9). (a) What is a *de facto* corporation?

(b) To what extent is a corporation bound by an agreement made by its promoters prior to and connected with its incorporation?

(a) A *de facto* corporation is one that, although it has failed fully to comply with the requirements for the proper formation of a corporation, nevertheless is deemed in fact to exist, provided the following elements are present:

(1) There is a law in existence under which such a corporation can be formed.

(2) There has been some colorable attempt to comply with such law, that is, a bona fide attempt to organize.

(3) There has been an exercise or use of corporate powers.

(b) The acts of a promoter, being not for himself but for the proposed corporation, are the acts of an agent without an existing principal. Hence, contracts of promoters, even though made in the corporate name and on behalf of the corporation to be organized, are not binding on the corporation unless adopted by it. (See sec. 743.)

1634. NY Oct. 1936 (9). Define *de facto* corporation. State the essentials to existence.

See sec. 1633.

1635. NY Oct. 1935 (10). Distinguish between corporation *de jure* and corporation *de facto*. What *three* elements are necessary to make a defective *de jure* corporation a *de facto* corporation?

A *de jure* corporation is one that has taken the steps required by law for its proper formation. A *de facto* corporation is one that, although it has failed fully to comply with the requirements for the proper formation of a corporation, nevertheless is deemed *in fact* to exist, provided certain conditions (set forth in sec. 748) are present.

A "defective *de jure* corporation" is an anomaly. If the organization is defective, the corporation cannot be *de jure*. Presumably, this question is intended to elicit the conditions requisite to establish a *de facto* status for a defectively organized corporation. These are set forth in sec. 748.

The principal distinction between a *de jure* and a *de facto* corporation is that the corporate existence of the latter can be successfully attacked by the state but by no one else, whereas no one, not even the state, may challenge the corporate existence of a *de jure* corporation so long as it continues to comply with the law. (See sec. 748.)

1636. AI Nov. 1943 (3). (a) What is a *de facto* and what a *de jure* corporation?

(b) What right has a stockholder to a share in the profits of the corporate business?

(c) In case of consolidation, what becomes of the debts and liabilities of the old companies?

(a) See secs. 1633 and 1635.

(b) Except where dividends are guaranteed, a stockholder has no inherent right to share in profits unless and until the directors in their sound discretion declare a distribution to be in order. If such discretion is palpably unsound, arbitrary or dishonest, a court may interfere to compel a distribution. (See secs. 850, 853 and 854.)

(c) In case of consolidation, the debts and liabilities of the old companies are assumed by the new company (sec. 896).

1637. AI May 1940 (2). (a) Give a brief narrative statement of facts that, in your opinion, should result in a decision that a *de facto* corporation existed.

(b) A corporation was organized with full compliance with all legal requirements except that the only capital stock actually issued was preferred stock that expressly provided that the stockholder had no right to vote on any matter whatsoever and had no voice whatsoever in the conduct or management of the corporation. Did a *de facto* corporation exist?

(a) The following facts should result in a decision that a *de facto* corporation exists:

(1) The incorporators have failed in some respects to comply with the requirements for incorporation.

(2) There is, however, a law in existence pursuant to which such corporation might properly have been formed.

(3) A colorable attempt has been made to comply with the law.

(4) Finally, the corporate function has in some manner been exercised, as by the making of some contract commitment on behalf of the corporation.

(b) Since the corporation was organized upon "full compliance with all legal requirements," it should be recognized as having *de jure* rather than *de facto* existence. The circumstance that *after* incorporation there was a failure to issue voting stock is immaterial, since "non-compliance with such a condition subsequent does not affect the existence of the corporation, although it may be ground for a proceeding by the

state to forfeit the charter.”³ Even assuming that the corporation were, for some reason, *de facto*, it would not lose its *de facto* existence by failing to issue its voting common and by issuing its nonvoting preferred instead. (It is assumed that voting common was *authorized*, since the question states that “the only capital stock *actually issued*” was the nonvoting preferred.) A stock corporation with no voting stock is an anomaly. It runs counter to the legal basis upon which such a corporation functions. Without voting stockholders, the corporation cannot function. If the only stock issued is designated in the certificate of incorporation as nonvoting preferred, the law in such case—abhorring a voting vacuum—would vest voting power in the preferred.⁴ In any event, a *de facto* corporation in such situation would not lose its *de facto* character through subsequent failure to issue stock, though its charter might be forfeited for corporate failure to function.

1638. **AI May 1939 (2).** *F, G, and H* on March 15, 1939, agree orally to begin business in corporate form on May 1, 1939, and they retain a lawyer who prepares the certificate of incorporation, which they execute on April 3, 1939. On April 10, 1939, *F* takes this certificate for delivery to the lawyer, but he inadvertently fails to deliver it. During the month of April 1939, *G* and *H* sign a lease for office space and make various other contracts, all in the name of the proposed corporation. The lawyer inferred that the matter of the proposed incorporation had been dropped and he did nothing further with respect to it. Can *F, G, and H* be held personally liable on the lease and the other contracts made in April? If so, would they be held jointly, severally, or jointly and severally liable?

F, G, and H cannot be held personally liable, since failure to file the certificate was not deliberate but inadvertent, and a court may well hold under the circumstances that there was a sufficiently colorable attempt at compliance with the filing statute to satisfy the requirements for *de facto* existence. Good faith, rather than substantial compliance, is the test. (See sec. 748.)

There is, however, a conflict in decisions as to whether a fail-

³ 18 *Corpus Juris Secundum* 425, citing *W. L. Wells Co. v. Gastonia Cotton Mfg. Co.*, 198 U.S. 177.

⁴ See *Rice & Hutchins, Inc. v. Triplex Shoe Co., et al.*, 16 Del. Ch. 298, 147 A. 317, aff'd 17 Del. Ch. 356, 152 A. 342, in which it was held that where the charter provides that the sole voting power shall rest with the common stockholders, and where no common stock has been legally issued, the preferred stock may vote

ure to file incorporation papers will bar *de facto* existence. This is due to variations in the language of different state statutes. In Michigan, for example, where the statute requires filing before the corporation "shall commence business," the Court held that *de facto* existence could be recognized notwithstanding a failure to file.⁵ Likewise, in Iowa, where the statute provides that a corporation *shall not do business* until its incorporation papers are filed, the court recognized *de facto* existence notwithstanding a failure to file.⁶ However, in states where the statute provides in effect that a corporation *cannot come into existence* unless incorporation papers are filed, courts have refused to recognize *de facto* existence in the absence of filing.⁷

In states where the latter rule prevails, *F*, *G*, and *H* would be liable as partners. Partnership liability, in states that have adopted the Uniform Partnership Act (pages 12-13), is joint; in states where the common law rule prevails, joint and several. (For the distinction between joint liability and joint and several liability, see sec. 175.)

1639. AI May 1936 (6). Eight men signed, acknowledged, filed, and recorded a paper purporting to be a certificate of incorporation under a state statute. They then issued capital stock to themselves, elected directors and officers, adopted by-laws, and began to do business. The purposes of the corporation stated in the paper so executed and filed were not authorized by the statute under which incorporation was attempted and the place where the business was to be conducted was not stated therein as required by the statute, but these errors were not detected in the office of the secretary of state until after the organization had been completed and some business had been transacted.

(a) Can the state successfully question the legality of the corporation?

(b) Can the eight men be sued as partners by a person dealing with the alleged corporation prior to any action by the state?

(a) The state can successfully question the legality of the corporation. Obviously, the corporation has no *de jure* existence. Neither is there *de facto* existence, since the first requisite to such existence is a statute that permits the corporate purposes intended.

(b) The eight men are personally liable as partners to a party with whom they may have contracted on behalf of the corporation, unless such party is estopped to deny corporate

⁵ *Tisch Auto Supply Co. v. Nelson*, 222 Mich. 196.

⁶ *Wilkin Grain Co. v. Monroe County Co-Op. Ass'n*, 208 Iowa 921.

⁷ See 8 Fletcher, *Cyc. of Corporations* 127, secs. 3818 and 3819.

existence (sec. 751). In the absence of *de jure* or *de facto* existence, incorporators are liable as partners. (See sec. 752.)

1640. NY Oct. 1943 (5). Five persons, who afterward formed a corporation and became its directors, entered into a contract before the corporation was formed. Later they entered into two other contracts, of which one was beyond the powers conferred upon them as directors and the other was *ultra vires* the corporation.

(a) Can all or any of these three contracts be enforced by or against the corporation?

(b) What subsequent actions by the corporation would satisfy you, as the comptroller of the corporation, that the first, second or third contract was enforceable?

(a) All three contracts may be enforced by and against the corporation under the conditions set forth in (b), below.

(b) The subsequent corporate action required to validate the contracts may be indicated as follows:

First contract: Presumably, this was not merely a contract establishing the rights and duties of the five persons among themselves but a contract made on behalf of the corporation to be formed. Such contract may be enforced by and against the corporation after it comes into existence, provided the corporation *adopts* the contract. (Secs. 743, 745.)

Second contract: Acts of directors that are beyond the powers conferred upon them by the charter and by-laws are ordinarily not binding upon the corporation, especially where such acts are contrary to statute and hence illegal. Acts that violate no statute but are unauthorized by the charter—that is, *ultra vires* acts—are governed by the rules specified in the succeeding paragraph. Acts that violate neither charter nor statute but that are unauthorized by the by-laws, may be enforced by the corporation, because by-laws are within the control of the directors or stockholders who formulate them, and stockholders may at all times ratify such unauthorized acts. Thus, the comptroller should be satisfied with a stockholders' ratification of such acts. Likewise, such contracts, if not illegal, may be enforced against the corporation, unless the party seeking enforcement knew that the acts were unauthorized. Such knowledge may be actual or constructive. Third parties are charged with knowledge of restrictions contained in a charter but not of those set forth in the by-laws, because the former is filed in a public place, the latter not (sec. 887).

Third contract: This contract, presumably, has not yet been

performed by the corporation. If it has likewise not yet been performed by the other party, neither party can enforce it. If it has been performed by the other party and the corporation has received the benefit of it, the corporation may be bound. If it has been performed by the corporation and the other party has received the benefit of it, the other party may be bound. (See sec. 886.)

1641. AI May 1936 (12). Colley, who was a promoter, announced that he was organizing a new corporation. He made a contract in the name of the corporation, prior to its incorporation, by which the corporation agreed to purchase merchandise from Russell. After the corporation was duly organized, Colley was unable to convince its directors and officers that it should purchase this merchandise and the corporation refused to accept it when it was duly tendered. Can Russell recover damages from Colley, or from the corporation, or from both of them?

Russell can recover damages from Colley but not from the corporation. A corporation is not bound by acts of a promoter unless it adopts such acts. If the acts fail of adoption, the promoter alone is bound (sec. 743.)

1642. NY Oct. 1940 (1). (a) Can a corporation be incorporated (1) to practice law, (2) without capital stock, (3) by an act of Congress?

(b) May the state, after granting a charter to a corporation, alter, amend or repeal it?

(a) (1) A corporation cannot be incorporated to practice law.

(2) Yes. Nonstock corporations are not only permissible but common. Examples are membership and religious corporations. (See sec. 739.)

(3) Congress may authorize the formation of corporations within territory under its jurisdiction, such as the District of Columbia, or as incidental to the exercise of Federal authority. (See sec. 746.)

(b) Yes. See sec. 746.

1643. NY Apr. 1938 (1). What information should an accountant expect to find in a certificate of incorporation?

Except for minor variations, the required contents of a certificate of incorporation are fairly uniform in the different states. An accountant should expect to find the following information in the certificate:

(1) The exact name of the corporation.

(2) The purpose or purposes for which the corporation is formed.

(3) Provisions relating to capital stock, including:

(a) (If all shares are to have par value) amount of capital stock, number and par value of shares.

(b) (If some or all shares are to have no par value) total number of shares that may be issued; number, if any, that are to have par value and the par value of each, number that are to be without par value, and a statement specifying a fixed ratio between the capital of the corporation and the aggregate value of the par and no-par value stock.

(c) (If shares are classified) the number of shares in each class, and all designations, preferences, privileges and voting powers of the shares in each class.

(4) Location of principal office of corporation (city, village or town, and county).

(5) Duration of corporation.

(6) Number of directors (or, that number shall not be less than a stated minimum nor more than a stated maximum).

(7) Names and post office addresses of directors until first annual meeting of stockholders.

(8) Name and post office address of each subscriber of the certificate of incorporation, and a statement of the number of shares he agrees to take.

(9) A statement that all subscribers are of full age, at least two-thirds citizens of the United States, and at least one a resident of the state, and that at least one of the directors is a citizen of the United States and a resident of the state.

(10) A designation of the secretary of state as agent for the corporation on whom legal process may be served.

(11) If board meetings are to be held only within the state, a provision to this effect (either in the certificate, or in the by-laws).

For comment on the above items, see secs. 756-763.

1644. AI-NY Nov. 1945 (1). (a) What essential information should an accountant expect to find in a certificate of incorporation?

Name five items that are of particular importance when making an audit.

(b) Define and differentiate between the capital and capital stock of a corporation.

(c) What is your opinion of the action taken by the board of directors of a corporation as to (1) dissolution, (2) amendment of the charter, (3) increase or decrease of capital stock, (4) consolidation with other corporations and (5) sale of all of the corporation's assets? Explain.

(a) For the essential information that an accountant should expect to find in a certificate of incorporation, see sec. 1643.

Five items in a certificate of incorporation that are of particular importance when making an audit are as follows:

(1) *Purpose.* Accounts receivable and their collectability may depend upon whether the activities in which such accounts were incurred were within the proper scope of corporate purpose and power. The same applies to accounts payable incurred by the corporation, especially where the outstanding obligation of the corporation is in connection with a wholly executory contract. See sec. 886, subd. (1).

(2) *Capital stock.* The amount of authorized capital stock is important in checking outstanding issuances of various classes to make sure that the same do not exceed their respective authorizations.

(3) *Duration.* Unless corporate duration is perpetual, it is important for an auditor to verify commitments that run for a long period, to make sure that the maturity date does not extend beyond the date fixed for expiration of corporate existence. For example, corporate bonds should not mature at a date subsequent to a date of expiration of a corporate charter.

(4) *Number of directors.* In auditing salary payments to directors, the alert auditor will verify the fact that the number of directors does not exceed the number authorized by the certificate of incorporation.

(5) *Subscribers to stock.* Initial stock subscriptions may have to be verified to make sure that such commitments are fully observed.

(b) Capital, as applied to corporations, means the value of the property actually received for stock issued by the corporation, plus subsequent additions thereto. Capital stock is a convenient mode of expressing collective ownership in a corporation. For further definition and differentiation between capital and capital stock, see sec. 770.

(c) The law generally provides that the corporate acts in question must be taken by vote of the stockholders instead of the directors, since the items in question are all of basic concern to the stockholders as a whole rather than matters for directorial policy. (See sec. 841.)

1645. NY Apr. 1937 (15). (a) Name the different classes of ownership interest that an individual may acquire in a corporation.

(b) Describe the rights or privileges and the limitations or liabilities of an individual of each class.

(a) Broadly speaking, the ownership interest that an individual may acquire in a corporation takes the form of a share or shares of the capital stock of the corporation.

The different classes of such shares of stock that an individual may acquire depend upon the classification provided for in the certificate of incorporation.

The certificate of incorporation may and frequently does provide for classification of shares into "common" and "preferred." Sometimes the common stock is further divided into subdivisional classifications such as Class A, Class B, Class C, and so on. Often, also, the preferred stock is classified into first preferred, second preferred, and so on. Preferred stock, also, may be cumulative or noncumulative, participating or nonparticipating. The capital stock of a corporation may also be issued on a par value or no-par value basis.

(b) The rights or privileges and the limitations or liabilities of an individual of each of the above classes necessarily depend upon the provisions in the certificate of incorporation. They may vary widely, depending upon the particular provisions specified by the incorporators in connection with any particular corporation. However, the more common provisions specifying the rights or privileges and the limitations or liabilities of the holders of each of the above classes of stock are as follows:

Common stock. The holder of this class of stock as a rule has a right to vote, but no right to dividends unless the directors see fit to declare them.

Preferred stock. The holder of this class of stock is as a rule given certain preferences over the holders of common stock. The more common preferences relate to dividends and to the distribution of assets on dissolution; that is, a preferred stockholder is ordinarily entitled to dividends ahead of a common stockholder, and if the corporation is dissolved and the assets are divided among the stockholders, the preferred stockholders are, as a rule, entitled to a prior distribution of net assets. However, preferred stockholders do not as a rule have the right to vote except upon default in fixed dividends or upon such other conditions as the charter may prescribe.

Cumulative preferred stock. If a dividend is not earned on

this class of stock, the obligation to pay it continues or accumulates until it can be paid.

Noncumulative preferred stock. If a dividend is not earned on this class of stock, the obligation to pay it ceases.

Participating and nonparticipating preferred stock. If earnings are more than sufficient to pay dividends on the preferred stock, the remainder may be given entirely to the common stock, in which case the preferred stock is nonparticipating; or such remainder may be distributed pro rata to both classes of the stock, in which case the preferred stock is said to "participate" with the common.

Stock that is given a fixed arbitrary value is called *par value stock*. Stock that has no fixed value is known as *no-par value stock*. The rights and privileges of the holders of par value stock are the same as those who hold no-par value stock; that is, the distinction between the two is not a distinction of rights and privileges to the stockholders but of the form that the stock issuance takes.

For a more detailed classification of the various classes of stock, see secs. 771-780.

Among the more common rights and privileges of stockholders are the following:

- (1) The right to a certificate.
- (2) The right to transfer the stock.
- (3) The right to vote (except as limited by the charter).
- (4) The right to dividends (absolute, if found in the charter; otherwise, discretionary with the directors).
- (5) The right to inspect books of the corporation.
- (6) The right to subscribe to new stock in proportion to stock already owned (pre-emptive right).
- (7) The right upon dissolution to a proportionate share of the net assets.

Among the liabilities of the holder of ordinary stock are the following:

- (1) Liability for any unpaid amount on stock subscription.
- (2) Liability for any difference between the face value of original issue par value stock and the actual amount paid thereon, or value given therefor.
- (3) Liability of holder of no-par value stock for any difference between the amount paid in and the price agreed upon

in the subscription agreement, or the value, if any, fixed in the charter. (See secs. 787 and 765.)

(4) Liability for unpaid wages of employees of the corporation under certain conditions fixed by statute.

1646. NY Apr. 1940 (5). To organize a new business, three persons execute and file a certificate of incorporation providing for a capitalization of 80,000 shares consisting of:

5% prior preference, par \$100, callable at \$105.....	10,000 shares
\$3 preferred, no par, callable at \$55.....	20,000 shares
Common stock, no par.....	50,000 shares

These three persons agree that, as full compensation for their services to that point, each shall receive 1000 shares of common stock.

Then they interest two other persons, and each of the five contracts to buy 1000 blocks, each block consisting of 1 prior preference, 2 preferred and 5 common at \$200 per block, to be paid in cash.

The agreements provide that one-half of each purchase is to be taken and paid for at once and one-half in one year from date, and that each will donate to the corporation 10% of the common received by him.

Eight months later, when all five persons have fully performed their matured agreements, they agree with a prospective purchaser of all of the stock that you may examine the corporation's records for the purpose of writing to him fully as to the status of its capital stock.

The prospective purchaser is not a bookkeeper nor accountant and does not want statements or journal entries that he would not understand, but wishes you to explain the status in a letter, though you may supplement that with a tabulation if you think that will clarify it.

Outline the substance of what you will give him.

Following is a summary of the status of the capital stock of the company:

Each of the three organizers originally received 1000 shares of no-par common stock, and each subsequently donated back to the company 10% of the common stock received by him. This meant that of the 3000 shares of no-par common stock thus issued, 90%, or 2700 shares, remained outstanding in the hands of the organizers and 10%, or 300 shares, became treasury stock.

Subsequently, the three organizers and two others paid into the treasury of the corporation the sum of \$200 for each of 1000 blocks, or \$200,000 each, making a total of \$1,000,000, for which there were issued:

5000 shares of prior preference (5 persons times one share times 1000 blocks), which, being original issue, par value stock, were presumably issued at not less than par (sec. 787).

10,000 shares of preferred, no-par value stock (5 persons times 2 shares times 1000 blocks).

25,000 shares of no-par value common (5 persons times 5 shares times 1000 blocks), which, in addition to the 2700 shares already issued, made a total of 27,700 shares outstanding.

A tabular summary of the various classes of stock, authorized, issued and outstanding, follows:

Class of Stock	Shares Authorized	Shares Issued	Returned to Treasury (Treasury Stock)	Shares Outstanding
(1) Prior preference	10,000	5,000	none	5,000
(2) Preferred	20,000	10,000	none	10,000
(3) Common	50,000	28,000	300	27,700

(1) The prior preference stock, presumably (although it is not stated that the certificate of incorporation so provides), has a first claim on dividends at the rate of 5%, or \$5 per share, and on assets in case of dissolution at the rate of \$100 per share. Unless the certificate of incorporation contains language to the contrary, dividends on preferred stock (including the class referred to in the following paragraph) will be deemed cumulative (sec. 777), that is, if it is not paid, the obligation to pay it carries over from year to year, whether the dividend is earned or not. The company may, if it has a surplus for such purpose, "call in" this class of stock, or retire it, by paying its holders \$105 per share.

(2) The \$3 preferred stock has no arbitrary or par value, but pays \$3 per share, presumably on a cumulative basis (see (1) above), and may be called in (out of surplus) at \$55 per share. The claim of this class of stock on dividends and on assets in case of dissolution is subordinate to the claim of the prior preference stock but preferred over the common stock.

(3) The common stock has no par or arbitrarily fixed value, no claim on dividends unless earned and declared, and (although not so stated here) is usually the voting stock. Of this class of stock, 300 shares are held by the corporation as treasury stock. These may be reissued. Until they are, they have no voting power nor any of the other rights of outstanding stock. (See sec. 774.)

Authorized but unissued stock of the company is as follows:

Prior preference.....	5,000 shares
Preferred.....	10,000 shares
Common.....	22,000 shares

1647. NY Apr. 1943 (8). The Great Northern Railway Company, chartered in 1889, had in its early years issued both common and preferred stocks. In 1890 the company re-acquired all its outstanding common stock, 4732 shares. Thereafter, it had outstanding only its \$6 noncumulative preferred stock without par value. Its fiscal years ended June 30th, until June 30, 1916. Then it had a fiscal period of 6 months to December 1916, and thereafter its fiscal years were the calendar years. During these 43 fiscal periods, it paid dividends per share as follows:

<u>Fiscal Years</u>		<u>Six Months</u>		<u>Calendar Years</u>	
1891.....	\$3.25	1916.....	\$3.50	1917-1921.....	\$7.00
1892-1897.....	5.00			1922.....	5.25
1898.....	6.00			1923-1930.....	5.00
1899.....	6.75			1931.....	4.00
1900-1916.....	7.00			1932.....	1.00

(a) Considering that this was a no-par \$6 preferred stock, which amount was paid in only one fiscal year, 1898, what is your understanding of the company's dividend policy during those 43 periods?

(b) Did the stockholders have ground for criticism of its policy?

(a) The company's dividend policy appears to have been based upon the theory that when common stock is retired, leaving preferred stock only outstanding, the latter assumes the character of common stock, upon which dividends may be paid in any amount or amounts currently justified by earning capacity, in the judgment of the directors. This is the only conclusion inferrable from the facts given.

(b) The only outstanding stockholders in a position to criticize are the holders of the \$6 noncumulative preferred. Assuming that their acquiescence over a long period of years would not bar them because of presumptive ratification and assuming that they would not be certainly barred by *laches* (sec. 102), their criticism might be that they were entitled to \$6 per year noncumulatively for each year that the earnings (in the directors' discretion) justified such payment, and not to the irregular dividend payments actually made. Although the withdrawal of all outstanding common stock might vest the voting power in the preferred (see sec. 1637), this is not tantamount to saying that the preferred thereby loses its guaranteed right to noncumulative dividends at the rate of \$6 per year. Whether the criticism is justified would depend upon whether, in the light of earnings, the directors abused their discretion. The facts would indicate no ground for criticism.

1648. AI Nov. 1936 (9). The authorized common stock of a corporation is 10,000 shares, of which 8000 are issued and outstanding. The board

of directors had authorized the retention of 2000 shares to meet conversion rights of preferred stockholders, which expire in 1940. The president of the corporation, who has held that office for five years, makes a written contract with the corporation for his services during the next five years, and as part of his compensation he is given an option to subscribe immediately for 1000 shares of common stock at a specified price above par. Is the contract valid as to this option?

The contract is not valid as to this option. "The statement by the defendant, in its certificate of incorporation and stock certificate, that any holder of preferred stock may convert such stock into common stock, imposed the obligation on defendant to use reasonable diligence to do everything necessary to keep itself in readiness lawfully to comply with its promise to convert its preferred stock on presentation and surrender * * *." ⁸ Since the board of directors had authorized the retention of 2000 shares to meet conversion rights of preferred stockholders, the presumption is that these shares were necessary for such purpose. The corporation was therefore charged with the obligation, in the language of the opinion above quoted, "to use reasonable diligence to do everything necessary to keep itself in readiness lawfully to comply with its promise to convert its preferred stock on presentation and surrender." The option given to the president to subscribe to 1000 shares of the stock thus kept in reserve conflicts directly with the obligation of the corporation to keep itself in readiness to convert the preferred stock on presentation. The option is therefore invalid.

1649. NY Oct. 1941 (2). (a) What is meant by *underwriting agreement*?

(b) Compare *underwriting agreement* with *stock subscription*.

(c) Discuss the liability, if any, of a subscriber for stock for the unpaid installments of his subscription (1) to the corporation, (2) to creditors of the corporation.

(a) See (b).

(b) A stock subscription is an absolute offer to buy stock. An underwriting agreement is "an agreement made before corporate shares are brought before the public, that, in the event of the public's not taking all of the shares or the number mentioned in the agreement, the underwriter will take the shares which the public does not take." ⁹

(c) A stockholder is liable to the corporation and to judg-

⁸ *Marony v. Wheeling & L.E. Ry. Co.*, 33 Fed. (2d) 916, 917.

⁹ *International Products Co. v. Vail's Estate*, 97 Vt. 318, 123 Atl. 194.

ment creditors of the corporation for the unpaid balance of his stock subscription with interest from the date of default. However, although the corporation may be barred by waiver or estoppel from recovering such balance, a judgment creditor would not be so barred. (See secs. 865-866.)

1650. AI Nov. 1937 (9). *X* was the secretary of a corporation that had been in existence for a number of years, and he was duly authorized to solicit subscriptions to unissued capital stock, the par value of which was \$100 per share. *X* induced *Y* to subscribe on July 1, 1937, for 100 shares at a total price of \$50 per share by telling *Y* (1) that the corporation's gross sales for July 1937 were certain to exceed \$20,000, (2) that the certificate of incorporation expressly empowered the corporation to conduct certain activities, and (3) that *Y* would not be liable to the corporation or to any other person or corporation for any amount in excess of the subscription price of \$50 per share. *Y* agreed to pay for this stock on September 1, 1937. On August 16, 1937, *Y* ascertained that the gross sales for July 1937, had been slightly less than \$5000 and that the certificate of incorporation did not grant the corporate power stated by *X*, and *Y* was informed by his attorney that he would be liable for an additional \$50 per share. Can *Y* immediately cancel his subscription agreement?

Y may cancel his subscription agreement.

Representation (1) as to future gross sales is not a representation of fact but of expectation, hence no basis for rescission on the ground of fraud (sec. 128).

Representation (2) as to what the certificate of incorporation provides raises the question as to whether *Y* had a right to rely upon such representation. If he had no such right, he cannot base a right to rescission upon such reliance (sec. 787). Was the public filing of the certificate of incorporation (as required by law) constructive notice to *Y* of its contents, so as to bar him from claiming a right to rely upon what *X* said as to its contents? Generally, third parties dealing with a corporation are chargeable with knowledge of restrictions contained in its charter, as distinguished from its by-laws, because a charter must be publicly filed but by-laws need not be. However, this rule is not uniform (see sec. 887, note 109).

Representation (3) that *Y* would not be liable for any amount in excess of \$50 per share, being a representation as to the law, is a statement of opinion (sec. 127), hence no basis for rescission.

However, the sale of original issue par value stock for less than its par value is in itself an illegal transaction (sec. 787), hence *Y* may cancel his subscription agreement.

1651. AI Nov. 1941 (5). *X* purchases from the *Y* Corporation 50 shares of its preferred stock, paying its par value. As a bonus, the *Y* Corporation issues to *X* 5 shares of its \$100 par common stock, the certificate for which carries the printed notation: "Full paid, nonassessable." In what circumstances, if any, can *X* be compelled legally to pay for this common stock?

X can be compelled to pay in a suit by a judgment creditor but not in a suit by the corporation or anyone who derives his rights directly from the corporation. The issuance of the 5 shares of \$100 par value common stock as a bonus was illegal, since original issue par value stock must be issued for its full par value, and no value at all was given for it, the 50 shares of preferred having been issued at full par value, as it was required to be under the law. However, the corporation, having participated in the illegal issue, is in no position to found an action upon it and is furthermore estopped by its representation that the stock was full paid and nonassessable. (See examples in sec. 865, subs. (1) and (2).) A judgment creditor, on the other hand, is barred by none of these factors. His right to sue is direct and is not derived from the corporation. (See sec. 866.)

1652. NY Apr. 1941 (8). (a) State how shares of a corporation are issued and transferred.

(b) How may the owner of a lost certificate of stock obtain a new one?

(a) Shares of stock are issued in the form of a certificate, designating the name of the holder, the number and kind of shares issued to him and the date of issuance. The certificate is signed by the proper officers of the company, with corporate seal affixed.

Stock may be transferred in three ways: (1) By delivering the certificate, duly indorsed on the back; (2) by delivering the certificate accompanied by a separate assignment; and (3) where stock is levied on, in execution of a judgment, by delivering the certificate coupled with an assignment executed by the sheriff or marshal who made the levy.

Ordinarily, when the owner of stock desires to transfer it, he affixes his signature to an assignment on the back of the certificate and his signature is customarily witnessed. The assignee's name is usually left blank, especially where the stock is traded in on a stock exchange, so that the holder may subsequently insert any name desired. The transferee presents his duly indorsed certificate to the proper officer or transfer agent of the corporation, who checks the certificate for proper in-

dorsement, verifies the transferrer's signature, sees that the proper tax stamps are affixed, and checks the old certificate with the stock list or ledger. If all is in order, he cancels and files the old certificate, issues a new one and registers the transfer.

(b) If a certificate is lost, stolen or destroyed, the stockholder may compel the corporation to issue a new one upon filing a bond indemnifying the corporation against liability should the old certificate turn up in the hands of an innocent holder for value. Ordinarily, a corporation will issue a new certificate upon an affidavit setting forth the facts in full, accompanied by an indemnity bond. Where the corporation refuses to issue a new certificate in such cases, a court order may be obtained to compel its issuance.

1653. AI May 1942 (4). (a) What are the principal functions of the board of directors of a domestic corporation?

(b) If no statute, provision in the certificate of incorporation, or by-law prohibits it, can such a board legally hold its meetings in a state other than the state of incorporation?

(c) Can a director, by virtue of his office as such, legally bind the corporation to a contractual or other obligation?

(d) Define voting trust and explain the purpose of it.

(a) Directors function as the original agency by which a corporation expresses its will and achieves its objectives. The principal functions of the directors are to establish and guide the policies of the corporation, elect its officers, furnish authority for their major acts, supervise their conduct generally, determine whether to declare dividends and approve all major steps and acts initiated and negotiated by the officers.

(b) If no statute, charter or by-law prohibits it, a board may as a rule hold its meetings in a state other than that of its incorporation. Formerly, the rule was to the contrary. The right to hold directors' meetings outside the state is now almost universally recognized, either specifically, by statute, charter, by-law, or majority vote of directors, or inferentially, from the fact that there is no specific provision against it.

(c) A director, by virtue of his office as such, cannot legally bind the corporation to a contractual or other obligation. (See secs. 796 and 806.)

(d) A voting trust is an agreement by which stockholders surrender their voting power and place it irrevocably in the hands of others. Its purpose is to permit stockholders to unite

upon a course of corporate policy or action, or upon the officers whom they will elect.

1654. **NY Apr. 1936 (5).** State (a) by whom the directors of a business corporation are elected, (b) by whom the officers are elected, (c) which of the officers, if any, of a business corporation must be a director.

(a) The directors of a business corporation are elected by its stockholders.

(b) The officers of the corporation are elected by its directors.

(c) As a rule, the president must be a director (sec. 809).

1655. **NY Apr. 1944 (1).** (a) Compare or contrast the following words that may be found in the Minute Book of a corporation, recording a meeting of the Board of Directors at which only one subject was considered: (1) Discussion, (2) Resolution, (3) Report, (4) Motion.

(b) In what sequence and in what way does the action arise that is indicated by each of the four words?

(a) See (b).

(b) It is customary for the board of directors to adopt the following procedure in connection with the official action of the board, in the order given:

(1) *Report.* The chairman calls for a report on a given matter, for example, a report of the financial condition of the company for the purpose of deciding whether or not to declare a dividend. The report is to advise the various members of the board on the facts as a basis for the formulation of a policy.

(2) *Motion.* It is then customary for a member of the board to make a motion that a given course be adopted upon the basis of the report made. Although meetings of the board are not necessarily along parliamentary procedure, it is customary, in a general way, to follow parliamentary procedure. Such procedure requires that there be no discussion on a matter until there is a pending motion for action of some sort. Hence, it is customary for a motion to be made in advance of discussion, although this procedure is not followed in many cases.

(3) *Discussion.* This involves an exchange of views among the members of the board.

(4) *Resolution.* A resolution is the formulated decision of the board. It may be the proposed form of action embodied in the original motion, or it may be a modified form of action as the result of amendment following discussion. If the resolution is adopted, it represents the formal action of the board.

1656. **AI Nov. 1936 (2).** Answer the following questions on the assumption that the certificate of incorporation (charter) and the by-laws of the corporation contain no provision applicable to the question and that the matter is not covered by a local statute:

(a) Can the president of a corporation, who is also a director, vote on a resolution fixing his salary as president?

(b) Can a person have rights as a stockholder before a certificate for stock for which he has duly subscribed and paid has been issued to him?

(c) What is a proxy and who may give one?

(d) When funds are turned over to a trustee for the payment of outstanding mortgage bonds and the trustee has been named in the mortgage as the trustee for the bondholders, is the corporation relieved from liability on the bonds?

(a) The president of a corporation, who is also a director, should not vote on a resolution fixing his salary as president. A director stands in a fiduciary relation to the corporation that he serves. He must not permit himself to act on behalf of the corporation if his action is tainted by self-interest. A director is, therefore, disqualified to vote at a meeting of the board if he has any personal interest in a matter before the board; neither can his vote, in such case, be counted in making up a quorum. (See sec. 800.)

(b) A person may have rights as a stockholder before a certificate for stock for which he has duly subscribed and paid has been issued to him, provided the arrangement is one for a *present subscription* and not merely a *contract to purchase* stock. In the former case, one becomes a stockholder when his subscription is accepted, regardless of whether the certificate has been issued or the price paid. (See secs. 783, 833.)

(c) A proxy is a power of attorney given by a stockholder, authorizing a designated person to cast the stockholder's ballot. Any stockholder may give a proxy.

(d) Funds are customarily turned over to a trustee for the payment of outstanding mortgage bonds pursuant to the provisions of the deed of trust under which the bonds have been issued. The trustee in such case, having been named in the mortgage or deed of trust as the trustee for the bondholders, the latter would have no recourse against the corporation if their trustee, having received the funds, thereafter defaults. Once the funds are turned over to a trustee for the payment of the bonds, the corporation has divested itself of control over the funds, and the bondholders' only recourse would be against the trustee.

1657. AI May 1938 (8). Under the by-laws of a corporation, the term of office of president was one year. Defendants and plaintiff together owned a majority of the voting stock and constituted a majority of the board of directors. They made a written contract, with consideration, that provided that plaintiff was to be annually elected president during a period of three years. Upon what ground, if any, could this contract be held invalid?

The contract could be held invalid on the ground that it is against public policy to contrive perpetuation in office by agreement or by dispensing with elections. Directors are supposed to exercise their untrammelled discretion in the selection of officers. (See sec. 805.) They cannot make the exercise of such judgment or discretion the subject matter of a bargain.

1658. AI May 1936 (2). The certificate of incorporation and the by-laws of a corporation provided that management of it was vested in its board of seven directors. A deed to land owned by the corporation was prepared in the name of the corporation and was signed by each director, but no two directors signed at the same time or place and no meeting was held or resolution passed. There were several hundred stockholders, and three of the directors were not stockholders. Was the deed effective to pass title?

Corporate deeds and other corporate instruments are usually executed on behalf of the corporation by officers whose authority is prescribed in the by-laws of the corporation; that is, the officers execute the instruments in question by authority of the board of directors. In this case, it is presumed that corporate authority to execute the deed and similar documents was not vested in any officers of the corporation, but rather in the directors themselves, since "management" of the corporation was vested in the board of directors. If this assumption is correct, the execution of the deed was not irregular because of signature by directors instead of by officers but rather because there was no regular board action. Ordinarily, official acts of directors must be done by the board convened as such, not by individual members of the board at different times and places. The principle in such cases is that the corporation is entitled to board action after deliberation and discussion among its members. It should be noted, however, that notwithstanding any irregularity in the execution of the instrument, if the corporation has received the benefit of the proceeds of the conveyance, it will be estopped from protesting its irregular execution of the deed.

A similar conclusion would be reached if the word "management," used in the above question, relates to the usual control vested in a board of directors and not to actual administrative management. In such case, the deed should properly have been executed by the officer or officers specified in the by-laws. However, notwithstanding such irregularity, if the corporation has received the benefit of the conveyance, it will be estopped from raising the question of irregularity in the execution of the deed.

1659. NY Apr. 1936 (6). May the board of directors of a corporation delegate its authority to agents or to a quorum composed of less than a majority of its members? May a director vote by proxy at a meeting of the board of directors? Give reasons for your answer in each case.

Boards of directors, especially in the larger corporations, commonly delegate authority to executive committees composed of less than a majority of their members. The Uniform Business Corporation Act provides in this connection that: "The board of directors may, by resolution passed by a majority of the whole board, designate two or more of their number to constitute an executive committee, who, to the extent provided in said resolution, shall have and exercise the authority of the board of directors in the management of the business of the corporation."

Ordinarily, directors may not delegate discretionary acts to others (sec. 795) because these under the law must be personally exercised by the directors themselves. However, directors may and usually do delegate purely ministerial acts either to officers or employees of the corporation or to an executive committee of the board itself.

In the case of *First National Bank of Binghamton v. Commercial Travellers' Home Ass'n*,¹⁰ the question arose as to whether a promissory note made by the defendant corporation was duly authorized when approved, not by the board of managers as such, but by an executive committee of the board consisting of one-third the total number of members on the board. Said the Court: "Defendant's board of managers consisted of 15 members, and that body appointed from its number an executive committee of 5, authorized by resolution to transact business in behalf of the board of managers when it was not in ses-

¹⁰ 108 App. Div. 708, 95 N.Y. Supp. 454, aff'd 185 N.Y. 575.

sion. It was by a majority of this executive committee, at a meeting held at the office of the defendant, that the treasurer testifies he was authorized and directed to execute and deliver the note in question. It is urged that the board of managers could not delegate the authority conferred upon them by the resolution to the executive committee, and hence the treasurer could receive no authority from it to sign the note. Of course, the board of managers could direct the treasurer, in pursuance of the authority conferred upon them by the resolution, to sign a negotiable note and deliver it to Green. Whether this was properly done through the medium of the executive committee, authorized to transact the business of the corporation when the board was not in session, is the only question involved. It is only discretionary powers respecting the affairs of the corporation that a board of directors or board of managers is prohibited from delegating to a subcommittee or an agent. They may vest the performance of merely ministerial duties in a committee of their own members, or in an individual." The Court then went on to say: "If the defendant can be deemed a business corporation, there can be no question but its board of managers would have power to appoint an executive committee of their own number to transact the business of the corporation during the interval between meetings of the board, and that the business might involve the giving of negotiable notes for legitimate indebtedness incurred. *Sheridan E. L. Co. v. C. N. Bank*, 127 N.Y. 522, 28 N.E. 467."

The right of a board to delegate authority to a quorum composed of less than a majority of its members is frequently given by statute. The New York statute, for example, provides:¹¹ "Unless otherwise provided a majority of the board at a meeting duly assembled shall be necessary to constitute a quorum for the transaction of business and the act of a majority of the directors present at such a meeting shall be the act of the board." But the same section goes on to provide: "*The by-laws may fix the number of directors necessary to constitute a quorum at a number less than a majority of the board, but not less than one-third of its number.*"

A director may not vote by proxy at a meeting of the board. (See sec. 1666, subd. (b).)

¹¹ *General Corporation Law*, sec. 27.

1660. AI May 1935 (9). How can a director of a corporation protect himself from possible liability when a majority of the board adopts a resolution that he believes to be wrong (a) when he is present at the meeting, and (b) when he is absent from the meeting?

A director may protect himself from possible liability when a majority of the board adopts a resolution that he believes to be wrong:

(a) *When he is present at the meeting*, by seeing to it that his dissent is recorded in the minutes.

(b) *When he is absent from the meeting*, by communicating his dissent in writing to the secretary of the corporation or by causing it to be entered on the minutes within a reasonable time after learning of the board action. (See sec. 831.)

1661. NY Oct. 1939 (2). From the viewpoint of a board of directors, discuss (a) dividends, (b) treasury stock.

(a) The declaration of dividends is within the discretion of the board of directors. Courts will not interfere with such discretion unless it is abused, through dishonesty, collusion or arbitrary conduct. Directors may declare dividends only out of surplus. If directors pay dividends out of capital instead of surplus, they incur liability at law to the corporation, in equity to creditors, and criminally, by statute. The law holds directors strictly accountable for any impairment of capital resulting from unwarranted dividends.

(b) In causing a corporation to acquire its own stock, or in disposing of such (treasury) stock after it has been acquired, directors must not prejudice the rights of creditors or stockholders of the corporation. The rights of creditors are prejudiced when directors cause a corporation to acquire its own common stock out of capital instead of surplus, because the capital of a corporation is a trust fund for the benefit of creditors. If a corporation disposed of all its capital assets in buying up all its outstanding stock, there would be nothing left with which to pay creditors. Moreover, if it is in the interest of a corporation that it should acquire its own capital stock, directors must refrain from acquiring such stock for themselves. And in disposing of treasury stock, directors must be equally free from personal interest. Treasury stock is "held in trust for the stockholders in such a sense that it must be disposed of for the equal benefit of all. In disposing of it, the directors or majority of the stockholders cannot discriminate

between the stockholders, or issue it to themselves, or to their nominees, either for the purpose of making a profit for themselves out of the transaction, or for the purpose of obtaining or retaining control of the corporation. If they attempt to do so, they commit a fraud upon the other stockholders, against which a court of equity will grant relief.”¹²

1662. AI Nov. 1936 (11). For what purposes may an action at law or in equity be brought in the name of a corporation against one or more of its directors or officers? State each purpose separately and specify the remedy or relief to be sought (e. g., damages or injunction).

Generally, an action may be brought in the name and on behalf of the corporation against one or more of its directors or officers for loss to the corporation by reason of breach of duty. Such breach of duty may take various forms. It may represent a deliberate diversion of corporate assets, profits or benefits to the directors or officers concerned. It may represent diversion of assets and profits to other persons, either through the deliberate act of the directors or officers or through their neglect or other misconduct. Officers and directors may also be negligent in failing to take proper steps to prevent loss to the corporation or, when such loss has occurred, in failing to take prompt steps to recover the loss on behalf of the corporation. Among the violations of duty for which officers and directors may be responsible to the corporation in an action brought on its behalf are the following: Profiting at corporate expense (sec. 814), taking personal advantage of corporate opportunities (sec. 815), dealings in corporate stock (sec. 816), dealings in corporate office (sec. 817), liability for negligence (sec. 819), preferential transfers (sec. 821), loans to stockholders (sec. 822), liability in connection with treasury stock (sec. 823), and liability for declaring dividends out of capital (sec. 824).

Ordinarily, corporate redress is sought through the appropriate corporate officers upon direction of the board. However, when the officers and directors are themselves the malefactors, they are unlikely to initiate legal action against themselves and on behalf of the corporation. In such cases, stockholders have a right to institute such action in the name and on behalf of the corporation against the offending directors and officers.

¹² *Ballantine on Corporations*, sec. 135.

In addition to actions for an accounting against officers and directors for damages by reason of their negligence, for moneys had and received and for similar forms of redress, injunctive relief may be sought against officers and directors where the wrongful acts complained of continue, or where other wrongful acts are threatened.

1663. NY Apr. 1938 (15). Would an examination of the stock ledger of a corporation indicate conclusively the owners of the respective shares? Explain.

An examination of the stock ledger of a corporation would not indicate conclusively the owners of the respective shares. Many shares are held in the name of nominees, trustees and other fiduciary representatives, without designation of the name of the beneficial or true owner. It is a common practice of traders on the stock exchange to have shares held, not in their own names, but in "street names," or in the names of their brokers, pending further instructions for the disposition of the shares.

1664. NY Apr. 1939 (15). (a) Name *three* ways in which the title to shares represented by a stock certificate may be transferred.

(b) Define bearer shares.

(c) Is the Uniform Stock Transfer Act a law in New York?

(a) The Uniform Stock Transfer Act provides:¹³

"Title to a certificate and to the shares represented thereby can be transferred only,

"(a) By delivery of the certificate indorsed either in blank or to a specified person by the person appearing by the certificate to be the owner of the shares represented thereby, or

"(b) By delivery of the certificate and a separate document containing a written assignment of the certificate or a power of attorney to sell, assign or transfer the same or the shares represented thereby, signed by the person appearing by the certificate to be the owner of the shares represented thereby. Such assignment or power of attorney may be either in blank or to a specified person.

"(c) By delivery of a separate instrument containing a written assignment of the certificate, or an interest therein, executed by the officer who levies an execution against property upon such certificate, or such interest therein, and sells the same, to the purchaser on the execution sale, and such assign-

¹³ Sec. 1.

ment shall, together with delivery of the certificate, effect a transfer of the title to the certificate, or the interest therein levied upon and sold as specified in such assignment, and the shares represented by such certificate, or such interest therein, to the purchaser at the execution sale.

"The provisions of this section shall be applicable although the charter or articles of incorporation or code of regulations or by-laws of the corporation issuing the certificate and the certificate itself provide that the shares represented thereby shall be transferable only on the books of the corporation or shall be registered by a registrar or transferred by a transfer agent."

(b) Bearer shares are shares represented by a certificate so made out as to entitle the bearer or holder to the shares in question.

(c) Yes; also in forty-five other states. (See pages 12-13.)

1665. AI May 1941 (11). (a) If a corporation desires to restrict the transfer of its stock by its stockholders, how, if at all, can it effectively impose a restriction?

(b) What financial risk, if any, does a person incur if he accepts office as a director of a corporation but completely fails to perform any of the duties of his office?

(c) In the absence of statutory or charter authorization, can a corporation become a partner in a partnership?

(a) If a corporation desires to restrict the transfer of its stock by its stockholders, it can effectively impose such restriction by inscribing it, or a notice of it, upon the certificates of stock, so that all purchasers thereof take them with notice of such restriction. (As to the circumstances under which such restrictions may be imposed, see sec. 837.)

(b) A director who accepts office but completely fails to perform any of its duties may become liable for failing to detect or prevent misconduct by codirectors. Thus if *A*, a wealthy director, leaves the active duties of the board to *B* and *C*, and *B* and *C*, by their misconduct, cause great loss to the corporation, the corporation may require *A*, *B* and *C* to account for such loss, and if *B* and *C* are without independent means, *A* may have to pay the entire judgment.

Directors may be negligent not only for failure to detect and prevent wrongs by codirectors but also for failure to redress such wrongs on behalf of the corporation after they were committed. The nonparticipating directors, in such cases, are

jointly and severally liable with the participating directors, whether their failure to act was deliberate or merely negligent.

(The various types of directorial misconduct for which innocent but neglectful directors may become liable are set forth in secs. 814 to 830 inclusive.)

(c) In the absence of statutory or charter authorization, a corporation cannot become a partner. (See sec. 878.)

1666. NY Oct. 1938 (3). (a) What is the purpose and intent of cumulative voting?

(b) May a director vote by proxy?

(c) How do small corporations avoid the trouble of sending out notices of meeting?

(d) May a proxy appoint another in his place?

(a) Cumulative voting is a device to assure minority stockholders a representation on the board of directors. It enables a stockholder to concentrate his voting strength on one or more directors to be elected, instead of spreading his votes over the entire slate. For example, suppose three directors are to be elected by two stockholders, one of whom, Major, owns 70 shares and the other, Minor, 30. By ordinary voting, Major will elect his entire slate. By cumulative voting, each stockholder may multiply the number of shares he owns by the number of vacancies to be filled, to make up his entire voting strength, which he may spread over the entire slate or concentrate on a single director. Thus:

Major: $70 \times 3 = 210$ votes (which, split three ways, cannot elect all the directors)

Minor: $30 \times 3 = 90$ votes (which, concentrated on one director, insures his election)

(b) Directors may not vote by proxy. They must attend personally to their duties as directors. "We know of no principle, applicable to the discharge of corporate functions, by which directors or trustees of the corporation can vote at the meeting of the board of directors or trustees by proxy."¹⁴

(c) Small corporations avoid the trouble of sending out notices of meetings by securing from their stockholders signed waivers of such notices.

(d) A proxy may not appoint another in his place unless especially authorized to do so by the terms of the proxy. As a

¹⁴ *Craig Medicine Co. v. Merchants' Bank*, 14 N.Y. Supp. 16, 19 (cited with approval in 274 Fed. 1011).

general rule an agent cannot delegate his power to exercise discretion, skill and judgment without the consent of the principal unless from the nature of the agency it appears that the necessity of employing sub-agents is contemplated.¹⁵ There is no necessity of employing sub-agents in the exercise of a proxy. Unless restricted by its terms, a general proxy confers discretionary, not ministerial, authority.¹⁶

1667. AI-NY May 1945 (3). (a) What sources may provide authority for cumulative voting of stockholders of business corporations?

(b) What is the purpose of cumulative voting and how does it operate?

(c) On the supposition that three directors are to be elected by two stockholders, of whom one, Abel, owns 70 shares and the other, Bach, owns 30 shares, illustrate how they could vote to get the best representation on the board of directors by (1) ordinary voting, (2) cumulative voting.

(d) May a director have another person attend directors' meetings and vote for him on his proxy? Explain.

(e) A corporation owns some of its own stock, which it carries in the name of the treasurer as trustee. May the treasurer vote the stock at an annual meeting of stockholders to elect directors?

(a) In some states the statute prescribes that directors shall be elected by cumulative voting. In other states cumulative voting is permitted if the charter or by-laws so provide.

(b) See sec. 1666, subd. (a).

(c) See sec. 1666, subd. (a).

(d) Directors may not vote by proxy. They must attend personally to their duties as directors. See secs. 795 and 1666, subd. (b).

(e) The treasurer may not vote the stock. See sec. 774.

1668. AI May 1935 (10). What is cumulative voting? For what purpose is it employed? How does it accomplish its purpose?

See sec. 1666.

1669. AI Nov. 1939 (3). (a) Define a dividend by a corporation.

(b) In what media other than cash may such a dividend be payable?

(c) State each step with respect to dividends ordinarily taken by a corporation with several hundred stockholders, and mention the rules or principles of law, if any, applicable to each step.

(a) A dividend, literally, is a fund to be divided. A dividend on stock is a distribution of profits to stockholders in proportion to their holdings.

(b) Besides cash, dividends may be payable in stock, property or *scrip*. (See sec. 848.)

¹⁵ 2 *Corpus Juris Secundum* 1357.

¹⁶ 5 Fletcher, *Cyc. of Corporations*, sec. 2060.

(c) The usual steps taken in connection with the declaration and payment of a dividend are:

(1) *Report of financial condition.* The directors must have before them a report of the financial condition of the company in order to determine whether, in the exercise of sound discretion, a dividend is both valid and justifiable. If the report discloses that no surplus exists, a dividend declaration would be illegal. If the report shows a surplus but also a glaring need to preserve the surplus intact, a dividend declaration might constitute a grave abuse of discretion. There are numerous factors that directors may be called upon to consider before approving a dividend declaration. (See sec. 853.)

(2) *Meeting of directors.* A dividend must be approved by directors at a meeting duly held for such purpose. The factors referred to in (1) must be officially discussed and decided. A canvass among the directors individually, with approvals thus secured, is not a satisfactory substitute for a duly convened meeting.

(3) *Resolution.* A dividend must be officially "declared" by a duly adopted resolution.¹⁷ The resolution must be recorded in the minutes of the meeting. Dividends are improper unless supported by a record of due authorization.

(4) *Announcement and notice.* In the larger organizations, where stock is so widely held as to make dividend declarations thereon a matter of public interest, it is customary to make public announcement of the dividend declaration. It is also customary to notify stockholders by mail of the dividend declaration. After such announcement and notification, dividends may not be revoked (sec. 857); the stockholders have become legally entitled to the dividend.

(5) *Payment.* The resolution usually provides for payment of the dividend to stockholders of record on a given date, and the treasurer of the corporation, or its fiscal agent, must see to it that payment is made to such stockholders on such date at the addresses given by the stockholders and recorded in the stock ledger.

1670. NY Oct. 1936 (14). Mention *three* differences between a dividend paid by a corporation and a dividend paid by a trustee in bankruptcy.

Three differences between a dividend paid by a corporation and a dividend paid by a trustee in bankruptcy are:

¹⁷ See, however, secs. 850 and 1674.

(1) A corporation can pay dividends only out of surplus; a trustee in bankruptcy pays dividends out of the corpus or assets in the estate.

(2) Corporate dividends are declared by the directors and paid by a corporate officer; dividends in bankruptcy are declared by the referee and paid by the trustee.

(3) Corporate dividends represent profits; dividends by a trustee in bankruptcy do not.

(See sec. 848.)

1671. AI May 1943 (3). The X corporation, upon the declaration of a dividend, does not segregate funds in an amount equal to the dividend declared but merely makes a bookkeeping entry crediting an account entitled "Dividends Payable."

(a) Is the corporation a trustee of funds for the benefit of the stockholders to the amount of the dividends declared?

(b) What is the relationship between the corporation and the holder of record of stock on which a dividend has been declared?

(c) Of what practical importance is the decision whether or not the corporation is a trustee?

(a) The mere dividend declaration accompanied by a bookkeeping entry was insufficient to create or establish a trust. Since no fund was appropriated to the trust, there was no subject matter, or *res*, to which the trust could attach. Hence, the corporation is not a trustee of funds for the benefit of stockholders in the amount of the dividends declared.

(b) The relationship in question is that of debtor and creditor.

(c) The decision whether or not the corporation is a trustee would be of practical importance in case bankruptcy should intervene between dividend declaration and dividend payment. Where a debtor becomes insolvent, general creditors are entitled only to a *pro rata* share of his assets. If a trustee becomes insolvent, the beneficiary has a prior right to so much of the trustee's assets as represent trust property or its proceeds. Thus, if the corporation, after declaring but before paying a dividend of \$50,000, sustained a severe loss and became adjudicated a bankrupt, with assets of \$250,000 and liabilities of \$500,000, the stockholders, if the dividend were a trust, would receive payment in full, and all other creditors (except those entitled to priorities) would share *pro rata* in the remainder. On the other hand, if the dividend were a debt, the stockholders, together with all other general creditors,

would receive, approximately, a 50% distribution on their claims.

1672. AI May 1941 (1). A certified public accountant, in his examination of a wholly owned subsidiary corporation, finds that its board of directors has declared a dividend in excess of the amount of surplus at the beginning of the year plus the net profit for the year, and that this dividend has been paid to the parent corporation. What should the accountant do with respect to this situation?

The accountant should call attention to this fact in his report. An accountant is not required, indeed he is not permitted, to advise as to the law. But all persons, whether lawyers or laymen, are chargeable with liability for infringing the law, since ignorance of the law in such case is no excuse. To this extent accountants should be especially aware of the possibilities of law infringement disclosed by their audits. Where facts are disclosed that indicate the possibility of law infringement, they should call attention to such facts so that the client may seek legal counsel and be governed accordingly. Here the law infringement was palpable: a dividend was declared, wholly or partly out of capital. Full disclosure and analysis of this fact should be made in the accountant's report, and particular attention directed to it.

(The directors of the subsidiary corporation, if they are properly advised, will take prompt steps to recover the dividend wrongfully paid. See sec. 852.)

1673. AI Nov. 1941 (10). A corporation has realized an operating profit and has a balance in its surplus account, but because of additions to fixed capital assets it has no cash beyond its requirements for working capital.

(a) Can this corporation legally declare a dividend (not a liquidating one)?

(b) On the assumption that such a dividend can legally be declared, how can payment of it be arranged?

(a) The corporation can legally declare a dividend, since it possesses a surplus.

(b) Payment of the dividend can be made in cash by borrowing money for this purpose. Such a loan is permissible under the law (sec. 852), though it is regarded as unsound business practice and is even prohibited in one or two states. Payment of the dividend may also be made in stock of the company (stock dividend), or in securities held by the company in its treasury, or in merchandise or other property (sec. 848);

or it may take the form of an interim certificate (scrip) entitling the holder to any of these things.

1674. **AI May 1938 (6).** On October 1, 1937, a corporation which had issued only no-par value stock had 2316 shares outstanding. This outstanding capital stock was carried at \$50,000 and the corporation's surplus was \$100,000. On that day the board of directors legally adopted a resolution directing the transfer of \$90,000 from the surplus account to the no-par value capital-stock account. Did this transaction constitute the declaration of a dividend?

The transaction did not necessarily constitute the declaration of a dividend, unless it was intended as such. The plan and purpose of the resolution would necessarily determine the character of the transfer. It may have been intended merely to effect a reduction of surplus and a corresponding increase in capital stock; it may have been part of a plan to declare a stock dividend; or it may have been intended as part one and part the other. Dividends should be declared by formal resolution, but any action by the directors indicating an intent to distribute profits will support a dividend payment.

"The transfer of surplus to capital immediately upon the completion of the corporate acts performed at the meeting of the stockholders, shows the entire thing was a part of one transaction carried out step by step as it was required to be in accordance with the law and in accordance with the plan, and must be interpreted as it was stated in the letter, an exchange in part and a stock dividend in part.

" * * * The mere creation and issue of new shares of stock upon the basis of surplus assets which thus became converted into stated capital, amounts to a stock dividend without denominating it as such. 2 Cook Corp. (8th Ed.) Sec. 536; *Alsop v. De Koven*, 107 Ill. App. 190.

* * * * *

"A formal resolution is not the only evidence of corporate action. * * * Everything that was said and done, the entire setting of the action, may help in determining the authorization intended to be conferred and the purpose to be carried out and effected." ¹⁸

1675. **NY Oct. 1937 (3).** A newly organized corporation issued one-quarter of its only authorized issue of capital stock to its incorporators for

¹⁸ *In re Norton's Will*, 129 Misc. 875, 224 N.Y. Supp. 77, 86, 87, 88.

all their rights in and to a group of patents, patent applications, drawings, plans, reports, and so on, for the production of an entirely new article of merchandise, the market for which was unknown and wholly speculative. Later, when the market had been developed, the corporation found that the inventions had an earning power and consequent value many times greater than the par value of the stock that it issued for the rights, and thereupon the corporation issued the other three-quarters of its capital stock to its stockholders in the same proportions as the first issue of one-quarter.

(a) As an accountant, state your opinion of the later issue.

(b) As an auditor, would you take any action? If so, what?

(a) An accountant should detect the presence of several legal questions raised by the facts stated and should advise that counsel be consulted in respect to them. He should refrain from giving legal advice in the matter, since it is unlawful to render legal opinions to clients unless one is licensed to practice law (sec. 45).

Two questions of law are raised by the facts: (1) Was the later issue an unlawful stock watering (sec. 787) operation? (2) Did the issue constitute a valid stock dividend?

(1) Since the later block was issued against adequate value, the stock cannot be deemed watered. Moreover, the increased capital value of the inventions remains with the original stockholders; there are no others.

(2) Assuming that the revaluation was properly reflected on the books so as to show a corresponding surplus, the later issue would represent a stock dividend out of such surplus. The declaration of dividends out of surplus is wholly proper.

The author is advised by competent accounting authority that careful accounting practice would require that the books indicate a distinction between earned surplus and surplus resulting from revaluation. The author is further advised that careful accountants discourage revaluation based on probable future earnings, especially where, as in the case of a patent, the period of monopoly earnings is definitely limited (17 years).

(b) A careful auditor would call the attention of the proper officer or director of a corporation to the principles above set forth and would qualify his certification accordingly. In other words, the auditor would consider that the transaction called for specific comment in his report, so that there could be no misunderstanding as to the source of the increased asset value reflected on the books of the corporation. Thus, if the item

"patents" is given a new value of \$100,000 in place of \$25,000, the auditor's comment should indicate that the increased value did not represent the acquisition of new patents but a revaluation of the old.

1676. NY Oct. 1942 (7). (a) Who may examine the stock books of a corporation?

(b) Who may examine the financial books of a corporation?

The question as to who may examine corporate books is determined by statute in many of the states, and the answer may therefore depend upon the statutory provision of a particular state. For a statement of the general rule governing the right to inspect (a) the stock books and (b) the financial books of a corporation, see sec. 858. This question, propounded by the Board of Examiners in New York, is answered by the law in New York as follows:

(a) "The stock book of every such corporation shall be open daily, during at least three business hours, for inspection by any judgment creditor of the corporation; or by any person who shall have been a stockholder of record in such corporation for at least six months immediately preceding his demand; or by any person holding or thereunto in writing authorized by the holders of at least five per centum of all its outstanding shares; provided (a) that such inspection shall not be for the purpose of communicating with stockholders in the interest of a business or object other than the business of the corporation, and (b) that such stockholder or other person has not within five years sold or offered for sale any list of stockholders of such corporation or any other corporation, or aided or abetted any person in procuring any stock list for any such purpose; and provided further that such inspection may be denied to such stockholder or other person upon refusal to furnish to such corporation or its transfer agent a written statement that such inspection is not desired for purpose (a) and that such stockholder or other person has not been connected with any stock list as provided in (b). Persons so entitled to inspect stock books may make extracts therefrom."¹⁹

(b) Under the law in New York, anyone standing in a fiduciary relationship to a corporation, with a claim based upon financial results (for example, a salesman whose commissions are based upon the extent of corporate profits), has a right to

¹⁹ New York Stock Corporation Law, sec. 10.

apply to the court, during the pendency of his action, for an order granting discovery and inspection of the financial books of the company. Any judgment creditor of a corporation may obtain a court order to examine the corporation in supplementary proceedings (sec. 73), in connection with which an examination of the financial books of the corporation may become proper.

A stockholder, for proper purposes and under reasonable regulations, has a common law right to inspect the financial books of his corporation. The Supreme Court of the United States, in referring to this right, says: "There can be no question that the decisive weight of American authority recognizes the common law right of the shareholder, for proper purposes and under reasonable regulations as to place and time, to inspect the books of the corporation of which he is a member. Morawetz, in his work on Private Corporations, sec. 473, vol. 1, says: 'However, in the United States the prevailing doctrine appears to be that the individual shareholders in a corporation have the same right as the members of an ordinary partnership to examine their company's books, although they have no power to interfere with the company's management.' " ²⁰

In many of the states, this right of a stockholder to examine the financial books of his corporation has been recognized in statutes which merely affirm the common law. In other states, the right continues to be recognized as a common law right, without statutory provision, as in New York, where the Court said, in *Matter of Steinway*:²¹ "We think that, according to the decided weight of authority, a stockholder has the right at common law to inspect the books of his corporation at a proper time and place, and for a proper purpose, and that if this right is refused by the officers in charge a writ of mandamus may issue, in the sound discretion of the court, with suitable safeguards to protect the interests of all concerned. It should not be issued to aid a blackmailer, nor withheld simply because the interest of the stockholder is small, but the court should proceed cautiously and discreetly, according to the facts of the particular case. To the extent, however, that an absolute right is conferred by statute, nothing is left to the discretion of the court, but the writ should issue as a matter of course, al-

²⁰ *Guthrie v. Harkness*, 199 U.S. 148.

²¹ 159 N.Y. 250 (at page 263).

though even then, doubtless, due precautions may be taken as to time and place so as to prevent interruption of business, or other serious inconvenience."

1677. NY Oct. 1939 (3). (a) Has a stockholder a legal right to inspect the financial books of a corporation? Explain.

(b) Would the officers of the corporation be required to allow a public accountant appointed by the stockholder to examine the accounts and make transcripts therefrom?

(c) Would the public accountant be termed a *del credere* agent?

(a) See sec. 1676, subd. (b).

(b) The officers of the corporation would be required to allow a public accountant appointed by the stockholder to examine the accounts and make transcripts therefrom, because what one has a right to do himself, he has a right to do through another; and a stockholder may himself not be professionally equipped to get the full benefit of an inspection to which the law may entitle him. As the court says in *Huyilar v. Cragin Cattle Co.*,²² in connection with a stockholder's right to inspect the financial books of a corporation: "Oftentimes frauds are discoverable only by examination of the books by an expert accountant."

(c) No. A *del credere* agent is a very different type of agent. (See secs. 545, subd. (i) and 1589.)

1678. NY Oct. 1935 (5). What books does the law require a business corporation to keep?

Generally, a business corporation must keep such books as will enable it to respond adequately to inquiries made or allowed under the law. For example, a minute book must be available to support proof of required action by stockholders or directors. Financial books must be kept as a covering record for tax and other purposes.

Specific books that a corporation is required to keep are frequently prescribed by statute. For example, the New York statute provides:²³ "Every stock corporation shall keep at its office correct books of account of all its business and transactions, and a book to be known as the stock book, containing the names, alphabetically arranged, of all persons who are stockholders of the corporation, showing their places of residence, the number of shares of stock held by them respectively,

²² 40 N.J. Eq. 392, 398.

²³ *Stock Corporation Law*, sec. 10.

the time when they respectively became the owners thereof, and the amount paid thereon. If any such corporation has in this state a transfer agent, such stock book may be deposited in the office of such agent, or may be kept in the office of the corporation, at its option, provided, that if kept in the office of the transfer agent there shall be posted in a conspicuous place in the office of the corporation a statement setting forth that fact with the name and address of the transfer agent where the stock book is kept."

1679. AI Nov. 1935 (2). A stockholder, exercising a legal right to inspect the financial books of account of the corporation, brought with him a public accountant to advise him in the examination and to make transcripts from the accounts to be taken away by the stockholder. The corporation's officers refused to permit the public accountant to see the accounts or to make transcripts therefrom. Were they justified in their refusal?

The corporation's officers were not justified in their refusal. See sec. 1677, subd. (b).

1680. AI and NY Nov. 1944 (5). (a) A stockholder of a corporation indorsed in blank his stock, which he delivered to a bank to hold as collateral security for a loan. The stock was in the name of the stockholder on the books of the corporation. The corporation had notice of the pledge.

(1) Who has the voting rights on this stock?

(2) Who is entitled to the dividends?

(b) Arnold, an employee of Bays, stole from Bays' safe, to which he had access as an employee, a certificate for 100 shares of stock that Bays had indorsed in blank. Arnold sold the stock to Cain, from whom Dodd purchased the stock in good faith. The corporation had transferred the stock to Cain, who appeared on its stock books as the owner of record at the time of purchase by Dodd.

What are Dodd's rights? Explain.

(a) (1) The stockholders has the voting rights. "Until title to corporate stock is perfected in the pledgee and the stock is transferred on the corporate books, the pledgor generally retains the voting power."²⁴

(2) The bank is entitled to the dividends. In the absence of agreement to the contrary, "The pledgee of stock ordinarily has the right and duty of collecting cash or stock dividends accruing during the pledge before payment of the debt and of applying them to the indebtedness, whether or not the transfer has been registered; and the corporation is liable therefor to the pledgee if it has notice of his interest, as is also a third

²⁴ 18 *Corpus Juris Secundum* 1244.

person collecting the dividend with knowledge of the pledge.”²⁵

(b) Dodd's rights are protected and his title to the stock will not be disturbed. The purchaser of stock issued after transfer of a stolen certificate is protected “regardless of the chain of events which led up to the issuance * * *.”²⁶ The Uniform Stock Transfer Act provides²⁷ that: “If the transferee has possession of the certificate or of a new certificate representing part or the whole of the same shares of stock, a subsequent transfer of such certificate by the transferee, mediately or immediately, to a purchaser for value in good faith, without notice of any facts making the transfer wrongful, shall give such purchaser an indefeasible right to the certificate and the shares represented thereby.”

1681. AI Nov. 1939 (7). Where one person properly has legal title to all of the capital stock of a duly organized corporation, in what circumstances will courts disregard the separate entity of the corporation and hold the sole stockholder personally liable for obligations incurred in the name of the corporation?

Where persons utilize the corporate entity for the achievement of illegal or fraudulent ends, the courts will penetrate the corporate fiction and deal directly with the realities. Thus, persons will not be permitted to evade existing debts and obligations by resorting to the corporate form of doing business. For examples, see sec. 870.

1682. AI May 1938 (10). (a) How, in general, does a corporation qualify to conduct business in a state other than the state of its incorporation?

(b) What risks does it incur if it conducts business without formally qualifying?

(c) What factors would you, as an accountant, take into consideration in rendering an opinion as to the desirability of a corporation's qualifying in a certain state?

(a) The license requirements for the purpose of authorizing foreign corporations to do business in a given state depend upon the laws of that particular state. The usual procedure is to file an application certifying the corporation's name, the date and state of incorporation, the nature of its business, the location of its principal office, the proposed registered office, the names and addresses of officers and directors, the name of the proposed resident agent on whom process may be served,

²⁵ 18 *Corpus Juris Secundum* 1177.

²⁶ *Rand v. Hercules Powder Co.*, 129 Misc. 891, 223 N.Y. Supp. 383.

²⁷ Sec. 8.

facts in reference to capitalization, value and similar information, together with a certified copy of the certificate of incorporation. This information must be accompanied by a registration fee.

(b) The risks that a foreign corporation may incur if it conducts business without qualifying vary in the different states. The most common risk is that of being deprived of the right to bring suit for the recovery of moneys justly due, or for other cause. (See sec. 875.) Other risks, depending upon the particular statutes of a given state, embrace personal liabilities and penalties imposed upon stockholders, directors and officers, such as liability for corporate debts, fines, and in some cases, imprisonment. (See sec. 876.)

(c) The factors to be considered in weighing the desirability of qualifying in a certain state are partly factual and partly legal.

The factual matters to be considered are the business advantages or disadvantages of such a step.

The legal matters to be considered are: (a) Whether the proposed activities would constitute "doing business," hence make it necessary to qualify as a foreign corporation; (b) the legal requirements for qualification; and (c) the legal risks incurred if the corporation fails to qualify and the activities conducted are subsequently construed as "doing business." If the writer were an accountant, he would refrain from rendering an opinion as to these matters, for to do so would constitute the unlawful practice of the law (sec. 45).

For further details as to what constitutes "doing business," see sec. 874; as to the legal requirements for qualification, see sec. 873; and as to the legal risks of "doing business" without qualifying, see subdivision (b) of this section, and secs. 875-876.

1683. AI May 1939 (7). A collection agency, incorporated under the laws of Missouri, makes a written contract in New York with a New York client, which recites that the collection agency "has executed and attested these presents at the City of St. Louis, to be effective from the date the acceptance is received at the office of the company at St. Louis, Mo." The agency has an active bank account in New York and it maintains an office there, where it has a staff of salesmen. It is listed in building and telephone directories in New York. It deposited the client's check in its New York bank account. The agency had not qualified, as a foreign corporation, to do business in New York. Would it be permitted to maintain an action against its client in the New York courts?

The agency would in all probability be permitted to maintain an action against its client in New York, because it is doubtful whether the acts in question would be construed as "doing business" in New York. Although building and telephone listings taken together with other facts sometimes constitute evidence of an intent to maintain a permanent and continuous business establishment, they are not in themselves conclusive. Acts relating to internal management, such as maintaining a bank account or a staff of salesmen, do not constitute "doing business" in the sense requiring a foreign corporation to obtain a license in the state. Making a written contract in New York, which is *not effective until accepted in Missouri*, is not "doing business" in New York. (See sec. 874.) Even in the absence of the provision that the contract was ineffective until approved in Missouri, it is doubtful whether this single, isolated transaction would be construed as "doing business" in New York.

1684. NY Apr. 1944 (10). A corporation holds an overdue note given to it by a stockholder for the balance of the price of a machine that the corporation had replaced with a larger one and that the corporation, acting by its directors, sold to the stockholder. The note is for only one-half of the sales price of the machine, on which the corporation is secured by a conditional bill of sale. However, the corporation has no use for the machine and would find it difficult to find another buyer. But the corporation's stock owned by the stockholder also has a present market value of more than twice the amount of the note and interest.

If the corporation should decide to proceed against the stockholder, what procedure may it adopt? Base your opinion solely upon the facts here stated.

If the corporation, under its conditional bill of sale, is unwilling to repossess itself of the machine and resell it, it may proceed against the stockholder by bringing suit upon the note. Having recovered judgment thereon and in the event that the judgment is not paid, the corporation may have its attorney issue execution (sec. 73). The sheriff or marshal may then levy on any property owned by the stockholder, including his shares of stock in the corporation, and may sell the same at a sheriff's or marshal's sale, in which event he pays over the proceeds to satisfy the corporation's judgment.

The mere fact that a stockholder is indebted to the corporation is in itself insufficient to create a lien on his stock. A statute, charter or by-law may provide that a corporation shall have a lien on stock not paid for, and a corporation, by charter

or by-law provision, may reserve the right to refuse to register a stock transfer unless the stock is fully paid (sec. 837). The Uniform Stock Transfer Act provides that a corporation has no lien upon stock nor any right to restrict its transfer unless such lien or right is noted upon the certificate.

If a corporation desires to obtain a lien on stock held by a stockholder for a debt unconnected with the stock purchase, it may do so by contract with such stockholder or by proceedings in execution of a judgment as outlined in the preceding paragraph.

1685. AI May 1940 (10). A contract between an individual and a corporation had been completely performed and the individual, in consideration of performance of the contract on his part, had received certain stocks and bonds from the corporation. The corporation now contends that the individual must return these securities to the corporation because the contract was *ultra vires*. Is its contention sound (on the assumption that the contract was *ultra vires*)?

The contention of the corporation is not sound. Where both parties have performed an *ultra vires* contract, neither party may sue to rescind it. (See sec. 886.)

1686. AI Nov. 1938 (3). A person, although not admitted to the bar, is permitted to act as his own attorney in court proceedings by or against him. Can the president or any other officer of a corporation, when duly authorized by the board of directors, act as attorney for the corporation in court proceedings by or against it?

This question was squarely raised in *Mortgage Commission v. Great Neck Improvement Co.*²⁸ It was contended that since a person was permitted to sue and defend in person, where he was personally concerned, the same rule should apply to a corporation. Acting on this theory, the defendant corporation, by its president (who was not a lawyer), served an answer and notice of appearance and filed an answering affidavit. The Court, reviewing the common law on the subject and the decisions in various states throughout the country, pointed out that corporations are universally prohibited from practicing law. Since, said the Court, the only way a corporation can function is through its officers and agents, a corporation cannot do through them what the law forbids the corporation itself to do. The Court then went on to say:²⁹ "Were it possible for corporations to prosecute or defend actions in

²⁸ 162 Misc. 416, 295 N.Y. Supp. 107.

²⁹ 295 N.Y. Supp. at p. 114.

person, through their own officers, men unfit by character and training, men, whose credo is that the end justifies the means, disbarred lawyers or lawyers of other jurisdictions would soon create opportunities for themselves as officers of certain classes of corporations and then freely appear in our courts as a matter of pure business not subject to the ethics of our profession or the supervision of our bar associations and the discipline of our courts."

The courts in other states have reached a similar conclusion.³⁰

1687. AI May 1941 (9). (a) How, in general, can a corporation be voluntarily dissolved?

(b) Give at least one example showing how a corporation can be involuntarily dissolved.

(a) A corporation can be voluntarily dissolved (1) by termination of its charter, (2) by merger or consolidation, (3) by filing without judicial proceedings a certificate of dissolution and (4) by judicial proceedings on petition for dissolution. (See sec. 899.)

(b) A corporation can be involuntarily dissolved by direct action of the state, for (1) nonuser, (2) fraud or fraudulent concealment in procuring a charter, (3) statutory violations, (4) forfeiture, surrender or abuse of the corporate privilege or charter, or (5) failure to exercise corporate powers or to do or refrain from some act amounting in effect to a surrender of corporate rights (for example, failure to pay taxes). Involuntary dissolution of a corporation by the attorney-general of a state may also be brought about at the instance of a creditor or stockholder under the circumstances set forth in sec. 900.

1688. AI Nov. 1940 (8). On May 28, 1939, the Benjamin Corporation procured a policy of fire insurance and the property covered thereby was destroyed by fire on June 25, 1939. Upon refusal of the insurer to pay

³⁰ *Mullin-Johnson Co. v. Penn. Mutual Life Insurance Company of Philadelphia, Pa.* (Cal.), 9 F. Supp. 175; *Nightingale v. Oregon Cent. Ry. Co.*, C.C. Or. 1873; *Bennie v. Triangle Ranch Co.*, 73 Colo. 586, 216 P. 718; *Nixon, Ellison & Co. v. Southwestern Insurance Company of Cairo*, 47 Ill. 444; *Nispel v. Western Union Railroad Company*, 64 Ill. 311; *Culpeper National Bank, Inc., v. Tidewater Improvement Co., Inc.*, 119 Va. 73, 79, 89 S.E. 118; *Union Pacific Ry. Co. v. Horney*, 5 Kan. 340; *Cobb v. Judge of Superior Court*, 43 Mich. 289, 5 N.W. 309; *New Jersey Photo Engraving Co. v. Carl Schonert & Sons, Inc.*, 95 N.J. Eq. 12, 122 A. 307; *Black & White Operating Co. v. Grosbart*, 107 N.J. Law, 63, 151 A. 630; *Cary & Co. v. Satterlee & Co.*, 166 Minn. 507, 208 N.W. 408; *In re Richards*, 333 Mo. 907, 63 S.W. 2d 672.

this loss, the corporation sued the insurance company. The latter defended on the ground that on December 15, 1937, the corporate existence of the Benjamin Corporation was terminated by proclamation under a statute of its state of incorporation because of its failure to pay its franchise tax. This statute provided that the corporate existence of a tax-delinquent corporation "shall immediately cease and shall be deemed dissolved without further legal proceedings" upon the publication of such a proclamation.

(a) Is the insurance company's defense valid?

(b) Would it have been valid if the action had been brought by a receiver duly appointed to wind up the corporation's affairs?

(a) The insurance company's defense is valid. Since the statute provided that corporate existence, upon proclamation under the statute, "shall immediately cease and shall be deemed dissolved without further legal proceedings," the Benjamin Corporation was not in existence when the purported insurance contract was made. After dissolution, only such corporate acts and transactions will be recognized as are necessary to complete liquidation and wind up corporate affairs, including unmatured and contingent assets, claims and liabilities. (See sec. 901.) Had the insurance policy been taken out as necessarily incidental to such purpose, its validity might not be questioned.

(b) Assuming that the policy sued on is the same one as that referred to in (a)—that is, a policy, taken out after dissolution, that was neither necessary nor incidental to the dissolution proceedings—the answer would be the same, whether suit on the policy was brought by the ex-corporation or by a receiver appointed to wind up its affairs. The assets and "affairs" of the corporation could not include a void contract (the insurance policy). The appointment of a receiver could not give life to that which did not exist.

CHAPTER IX-A

Guaranty and Suretyship

1689. NY Oct. 1938 (5). (a) What is a guaranty?

(b) What is a contract of suretyship?

(c) What right has an insurance company to cancel a policy once issued by it and accepted by the insured?

(d) What is meant by the pro rata clause in an insurance policy?

(a) A *guaranty* is a collateral undertaking by one person to answer for the debt or default of another person who is liable in the first instance on some independent contract of his own.

(b) A *contract of suretyship* is a contract by which one person agrees to answer for another's debt, default or miscarriage of duty.

In practice, the words "guaranty" and "suretyship" are frequently used interchangeably, not only by laymen, but by lawyers and courts as well. Even the United States Supreme Court has said, "A contract of guaranty is the obligation of a surety."¹

However, certain technical distinctions are sometimes made between suretyship and guaranty.

(1) A surety becomes liable simultaneously with his principal, upon the same undertaking, the same consideration, and usually the same instrument, whereas a guarantor becomes liable at a different time from that which marks the origin of the principal's liability, and likewise by a different instrument and often upon a separate consideration from that on which the principal is bound. Principal and surety, in other words, are usually bound on the same identical contract, and the surety is thus definitely obligated from the start; whereas the guarantor's undertaking is separate and collateral, and the liability assumed by it does not come into actual existence unless and until the principal defaults.

(2) A surety, being obligated on the same undertaking with

¹ *Davis v. Wells*, 104 U.S. 169.

the principal, is chargeable with knowledge of the principal's default, and is therefore liable without notice immediately upon such default. A guarantor is usually entitled to notice of the principal's default.

A common illustration of a contract of suretyship is furnished by an ordinary bond, by which *both* principal and surety are jointly and severally "held and firmly bound."

(c) See sec. 1724, subd. (c).

(d) See sec. 1724, subd. (d).

1690. NY Apr. 1940 (3). (a) Define guaranty.

(b) Before *A* sells a bill of merchandise to *B*, *C* tells *A* that he, *C*, will guarantee the payment therefor by *B*. Is that guaranty enforceable?

(c) After *A* sells a bill of merchandise to *B*, *C* writes *A* that he, *C*, will guarantee the payment therefor by *B*. Is that guaranty enforceable?

(d) Compare the facts in (b) and (c) above and state your reasons for your answer to each.

(a) See sec. 1689, subd. (a).

(b) The guaranty is unenforceable. The expression "*C* tells *A*" implies that the guaranty was oral. An undertaking to answer for the debt of another must be in writing.

(c) The answer to this question is not uniform in the different states. It should be noted that the promise in this case is based on past consideration. In New York and other states where a written promise based on past consideration is binding (sec. 150), the guaranty would be enforceable. In states which adhere to the common law rule of contracts that a promise based on past consideration is not binding, the guaranty would be unenforceable. (See sec. 915.)

(d) The distinction between the two situations, and the reasons for the answers given, appear in (b) and (c) above.

1691. NY Apr. 1941 (11). *W* was employed by *A E* corporation, of which *Q* was an officer. *A E* owed *W* \$9000 back salary. *W* demanded payment and *Q* told *W* that he would pay the money himself in a few days if the corporation did not do so. *Q* also wrote *W* a letter reading as follows: "I will personally see that it is taken care of in a few days, as this is my responsibility." *W* sued *Q* for the salary. Can he recover? Give reasons.

What *Q* told *W* does not amount to an enforceable guaranty, since a promise to answer for another's obligation must be in writing (sec. 917). If *Q*'s promise were of direct benefit to himself, that is, if it were an original undertaking (secs. 918-922), the writing would be unnecessary, but such is not the

case merely because the promissor happens to be an officer or stockholder of the corporate principal.

Q's letter to W, however, constituted a written guaranty. The promise, having been given after the credit was extended, was based on past consideration. A promise based on past consideration is binding in some states and not in others. In New York, for example, such promise was unenforceable prior to the statutory amendment which made past consideration sufficient to support a written promise.

1692. NY Apr. 1943 (7). The president of a corporation, acting for it, engaged a certified public accountant to make an examination of its accounts. After the CPA had begun his examination, he found that the corporation was short of working capital and a large part of its liabilities were long overdue. Thereupon, the CPA asked the president to guarantee payment of the fee, which he did in writing. However, when the CPA's report was delivered, the president refused to pay personally and said that the CPA must look to the corporation.

Explain the respective liabilities of the corporation and of its president.

The corporation is liable since, acting through its responsible head, it engaged the CPA's services. The president would also be liable personally on his guaranty in states which recognize past consideration as sufficient to support a written promise. He would not be liable in states which observe the common law rule that a promise (oral or written) based on past consideration is unenforceable. (See sec. 1691.)

1693. NY Apr. 1942 (6). A customer's ledger shows an account with William Brown which contains numerous charges, many past due, and the notation "guaranteed by John Smith," whose credit is known to be more than ample for the amount due from Brown.

(a) What would be your opinion as to the liability of Smith?

(b) Upon what rule or law would you base your opinion?

(a) Smith would be liable if such guaranties were in writing, otherwise not.

(b) A promise to answer for another's debt must be in writing. In New York and other states which recognize past consideration as sufficient to support a written promise (sec. 1691), it would not matter whether Smith's guaranty of Brown's account were given before or after the charges were incurred. In states where past consideration will not support a promise, written or oral, Smith's written guaranty would be binding only if given before or upon the extension of credit, not after.

1694. **AI May 1939 (11).** During a time of financial stress, the Clearing House Committee in a certain city promised a banker in that city and the United States Comptroller of the Currency that, if the banker would accept the presidency of a certain bank, the committee would protect the depositors of that bank and prevent the bank's failure.

(a) What is the relation between a bank and its depositors?

(b) Was the above promise subject to the statute of frauds?

(c) If your answer to (b) is in the affirmative, what provision in said statute applies to this promise?

(a) The relation between a bank and its depositors is that of debtor and creditors.

(b) The above promise was not subject to the statute of frauds.

(c) The answer to (b) being in the negative, no further comment is required. However, it may be noted, as supporting the answer given in (b), that a promise not made to the creditor or obligee is not a collateral undertaking or guaranty, but rather an original undertaking, in the nature of an indemnity. Hence the promise is binding, though oral. (See sec. 919.)

1695. **AI May 1937 (10).** Wilson, Barrett, and Keen organized a corporation, Wilson acquiring 90% of the capital stock and Barrett and Keen each acquiring 5% of it. Subsequently, Wilson legally acquired the stock owned by Barrett and Keen, thus becoming the sole stockholder. Thereafter, the corporation incurred a valid debt and, later, Wilson orally promised the creditor that Wilson would pay this debt if the corporation failed to pay it. If the corporation defaults, can the creditor compel Wilson to pay?

The creditor cannot compel Wilson to pay. Wilson's promise was not an original, but a collateral undertaking. Hence it was governed by the statute of frauds and, being oral, was unenforceable. A promise by a sole or controlling stockholder to make good the debt of a corporation is outside the statute of frauds (that is, binding, though oral), only when it is intended that the stockholder is to become primarily liable as the principal debtor.² But when the corporation is to continue as the principal debtor, a stockholder's promise to make good a corporate debt, though beneficial to the stockholder, is within the statute (that is, must be in writing).³ See sec. 921.

1696. **NY Apr. 1936 (10).** Mention five acts that will discharge a surety or guarantor from his liability.

² *Bulkley v. Shaw*, 289 N.Y. 133.

³ *Richardson Press v. Albright*, 224 N.Y. 497.

(Since the question calls for *acts* that will discharge a surety or guarantor, it excludes infirmity either in the principal contract, or in the contract of guaranty or suretyship; these being *facts* rather than *acts*.)

Acts that will discharge a surety or guarantor are:

(a) Any variance of the surety's contract or risk, without his consent, such as:

(1) Variance in parties.

(2) Variance in extent of principal's commitment.

(3) Variance in amount, place, time or manner of making payments.

(4) Change in duties of principal.

(5) Surrender, substitution or change of security.

(b) Performance by the principal debtor.

(c) Release of the surety.

(d) Release of the principal debtor.

(See secs. 926-927.)

1697. AI Nov. 1939 (10). If a mortgagor and a mortgagee of real property validly agree to a reduction of the interest rate but fail to notify a guarantor of the mortgage, who does not learn of this reduction until the maturity of the debt, is the guarantor thereby released from his guaranty of the principal of the mortgage?

The guarantor, in most states, would be released under the rule that any variance of the principal contract, without the surety's consent, whether detrimental to the surety or not, releases him (sec. 926). The reasoning in support of this view is that a surety is liable only on the contract which he guarantees, and a modified contract, whether beneficial or detrimental to the surety, is not the contract he guaranteed. The minority view is that a variance does not and should not discharge the surety unless it increases the surety's risk, and a beneficial variance does not increase the surety's risk.

1698. AI Nov. 1941 (12). Smith, Brown & Co., a partnership, is about to become indebted to Curtis & Co., another partnership, and the latter procures a surety for the payment of this obligation. One Jessup is a member of both firms. If Curtis & Co. does not reveal this fact to the surety at the time when it procures the surety, is the surety for that reason released from liability?

Whether Jessup's membership in both firms would release the surety would depend upon the materiality of such fact to the risk. "A concealment or nondisclosure sufficient to oper-

ate as a release of the surety . . . must be a material or inducing concealment. It must be a concealment of some fact known to the obligee and unknown to the surety, which bears upon the particular transaction to which the suretyship attaches, and materially affects or increases the surety's risk or liability to his prejudice, and which, if known, would influence the surety in regard to entering into the contract."⁴

The facts presented in the above problem are identical with the facts presented in the case of *Jungk v. Holbrook*,⁵ wherein the Court held that the fact of Scott's common membership in both firms, had it been known to the sureties at the time they signed, might have caused them to act differently, and the intentional concealment of such fact constituted such a fraud upon the sureties as to relieve them of liability.

1699. AI May 1938 (2). Jones, in writing, guaranteed payment for merchandise to be sold by White to Baker, and after such sales had been made Baker gave to White a nonnegotiable note, payable on demand, for the amount agreed to be due. Jones had no knowledge of the giving of this note until Jones, as surety, was sued by White upon Baker's failure to pay. Was Jones released from liability by White's accepting this note?

White's acceptance of the note did not release Jones from liability.

"The taking of additional or substituted security, such as a bond, bill or note, by the person in whose favor the guaranty operates does not release the guarantor, for it in no way changes his contract . . . unless in connection with the giving of such security there is, without the guarantor's consent, an extension of time for payment or performance. . . ." ⁶ Assuming its validity as a written promise based on past consideration (secs. 150 and 1690, subd. (c)), the demand note given by Baker to White did not operate as an extension of time. In states which do not recognize past consideration as sufficient to bind a promise, written or oral, the note would be of no effect, because it was nonnegotiable, and a pre-existing debt is sufficient as consideration for a note only when the note is negotiable (sec. 261, subd. (4) (a)). Hence the note, from any aspect, was ineffective as a variance of the principal obligation.

⁴ 50 *Corpus Juris* 57.

⁵ 15 Utah 198, 49 Pac. 305.

⁶ 38 *Corpus Juris Secundum* 1249.

1700. AI-NY May 1945 (11). (a) In a surety contract for future obligations of the principal, what are the rights of a creditor, on the death of the surety,

(1) As to the estate of the surety?

(2) As to obligations incurred by the principal before and after notice to the creditor of the surety's death?

(b) Albert is surety for the partnership firm of Bixby and Cort on a bond to the extent of their purchases. Without Albert's knowledge, another partner, Dixon, was taken into the firm. Subsequently, Albert was sued on the bond with respect to a purchase made by the firm after Dixon had entered it. Is Albert liable? Why?

(c) Alec, an infant, enters Burton's employ, furnishing Burton his bond with Chase as surety for faithful performance of his duties. Alec defaults.

(1) Burton sues Alec, who pleads infancy. Can Burton recover from Alec? Explain.

(2) Burton sues Chase on the bond. Chase pleads Alec's infancy as a defense. Can Burton recover from Chase, the surety? Explain.

(a) (1) In a surety contract for future obligations of the principal, the estate of the surety is liable for all obligations incurred up to the date of the surety's death and for all further contingent obligations under the contract, unless such contract was revocable at the surety's option during his lifetime, in which event all future contingent obligations under the suretyship contract will automatically cease upon the surety's death.

(2) "Where the guaranty is one which could be ended at the will of the guarantor while living . . . it will be terminated as to future transactions by his death and notice thereof, but such termination will not affect transactions which were executed prior to such death."⁷

(b) Albert is not liable. "Where a guaranty is made with reference to credit proposed to be extended to a firm, a change in the firm, such as by the retirement of one of the partners, will release the guarantor from liability for credit thereafter extended. . . ."⁸

(c) (1) Burton cannot recover from Alec. Infancy is a good defense in contracts not involving necessities to the infant.⁹

(2) Burton can recover from Chase. A surety for an infant is not relieved of liability because of the principal's infancy; such defense is personal to the infant principal.

⁷ 38 *Corpus Juris Secundum* 1175, and cases therein cited.

⁸ 38 *Corpus Juris Secundum* 1232.

⁹ As to business contracts of an infant, see sec. 137.

Neither may Chase plead discharge on the ground of infirmity in the principal contract, since the principal contract in such case is voidable, not void.

1701. **AI Nov. 1935 (9).** The Surety Company was a duly organized corporation engaged in the business of issuing surety bonds. In consideration of its regular fee, it became surety on the official bond of a municipal treasurer. The treasurer defaulted and the municipality took his six-month note for the amount of the shortage, but the Surety Company was not notified. The treasurer failed to pay the note at its maturity, and the municipality sued him and the Surety Company for the amount of the shortage. Upon trial it appeared that there had been no substantial change in the treasurer's financial condition during the interval between the discovery of the defalcation and the starting of the suit. Was the Surety Company discharged from liability when the municipality accepted the treasurer's note?

On the facts stated, liability would depend upon a jury's finding as to whether a six months' delay in notifying the surety company constituted a failure to give reasonable notice. If this were a gratuitous suretyship, the municipality would have been required to give notice of defalcation immediately upon discovery. In the case of a surety company bond issued for a premium the requirement of notice, if none were stipulated, would be less stringent, although the point is somewhat academic, since fidelity bonds almost invariably contain a stipulation as to notice of defalcation. A common provision is: "On discovery of any fraudulent or dishonest act on the part of the employee, the employer shall give immediate written notice thereof to the company, with the fullest information obtainable at the time." "Immediate notice" has been construed as notice with reasonable promptness under all the circumstances.

In determining whether the notice given was reasonably prompt, it would be pertinent to inquire whether the surety company suffered any prejudice by the delay. "With the aid of prompt notice the insurer might be enabled to recover embezzled property which otherwise would be squandered or dissipated; or to anticipate the flight of an absconding defaulter and, by his arrest, to enhance the chances of pecuniary restitution."¹⁰ (In the case here given, no prejudice was suffered because of the delay, since there had been no substantial change in the treasurer's financial position during the interval

¹⁰ Richards, *Insurance*, Third Ed., 659.

between discovery and notice.) If a jury should find, under the circumstances, that reasonable notice was given, the Surety Company would be liable, otherwise not.

1702. **AI May 1944 (10).** (a) What effect does the release of the principal debtor have on the liability of the surety, and why?

(b) Does the discharge of the principal debtor in bankruptcy release the surety?

(c) If the principal debtor is discharged under a composition agreement does this release the surety?

(a) An unconditional release of the principal debtor by the creditor discharges the surety. The creditor cannot excuse performance on the one hand, and yet insist on responsibility for nonperformance on the other (sec. 927, subd. (c)). A creditor may, however, qualify his release by reserving his rights against the surety, in which event the surety may in turn have recourse against the principal debtor (sec. 927).

(b) The discharge of a principal debtor in bankruptcy does not release the surety since a discharge by operation of law is involuntary. To discharge the surety, a release must be voluntary.

(c) A composition agreement, being voluntary, discharges the surety (sec. 927, Example).

1703. **AI May 1943 (2).** (a) Explain briefly and illustrate each of the following rights of a surety: (1) to exoneration, (2) to contribution, (3) to indemnity, and (4) to subrogation.

(b) *X*, a citizen and resident of one country, was legally indebted to *Y*, a citizen and resident of another country, and *Z*, a citizen and resident of the second country, was surety for *X*. Before the debt became payable, these two countries went to war against each other. What effect did this war have on the rights of *Y* against *X* and *Z* (assuming no war legislation or executive regulations in either country which would be applicable to this situation)?

(c) A surety company duly guaranteed the honesty of *X*'s cashier. Thereafter, the cashier embezzled *X*'s funds, which *X* discovered, but *X* did not discharge the cashier nor did *X* notify the surety company. Still later, the cashier committed a further embezzlement, whereupon *X* discharged him and notified the surety company. Is the surety company liable to *X* for either part or both of these thefts?

(a) (1) *Exoneration* (literally, relief from a burden) is the remedy afforded a surety (when the principal debt has matured) of bringing an action in equity to compel the principal to pay the debt. (See sec. 932.) The remedy may also be

applied by a surety, upon the principal's default, to compel contribution among the cosureties, even before any one surety has made good the debt.

Example: *X*, *Y* and *Z* are cosureties for *P*. Upon maturity of the debt, *X*, *Y* and *Z* may, in special circumstances, bring suit in equity to compel *P* to pay the creditor. Likewise, in special circumstances, *X* may, upon *P*'s default, compel equal contribution among *X*, *Y* and *Z* of their respective shares of *P*'s debt which they must now make good to the creditor, in place of the usual procedure for contribution among sureties described in (2).

(2) *Contribution:* When one of several cosureties makes good the principal's default, he may compel contribution from the others in proportion to their respective shares of the excess paid by the surety who has made good the default. (For an example, see sec. 933.)

(3) *Indemnity (reimbursement).* The law raises an implied promise by the principal debtor to indemnify the surety or guarantor to the extent of his loss in making good the principal debtor's default. (See sec. 931.)

Example: *G* guarantees *P*'s debt to *C* in the amount of \$5000. Upon *P*'s default, *G* makes good to *C* in the amount of \$2500, promising more later. He is now entitled to reimbursement from *P* in the amount of \$2500. If he collects that amount and pays it over to *C*, he may again seek reimbursement of \$2500 from *P*.

(4) *Subrogation:* To "subrogate" is to substitute one person in the place of another. If a surety has paid the *entire debt* defaulted by the principal, he is entitled to demand and obtain possession of any security deposited by the principal with the creditor. This is what is meant by the expression that by virtue of subrogation, the surety "steps into the creditor's shoes." Unlike the remedy of indemnity or reimbursement, subrogation is not available unless the surety has made good the entire debt. (For an example of subrogation, see sec. 1705.)

(b) *Y*'s rights against *X* are suspended by hostilities between their respective countries (sec. 142), but his rights against *Z* are unimpaired, since *Y* and *Z* as citizens and residents of the same country, are unaffected by the fact that their

own country is at war with another country. The law gives a surety who has made good his principal's default, a remedy against such principal. The creditor's remedy against the surety, however, is not dependent upon the surety's remedy against the principal, and the suspension of the latter remedy does not suspend the former.

(c) The surety company is liable to *X* on the first offense, but not on the second. Failure of *X* to notify the surety company of the first theft, and to discharge the cashier thereon, discharged the surety company on the second theft. (See sec. 937, "Fidelity bonds: conditions of liability.")

1704. NY Oct. 1936 (11). What are a guarantor's remedies when he has paid his principal's debt or obligation? Has the guarantor any additional remedy when he is a coguarantor? If so, state the remedy.

A guarantor, when he has paid his principal's debt, may have one of two remedies: (1) subrogation, or (2) indemnification. Besides these remedies against the principal debtor, a guarantor may have the remedy of (3) contribution as against his coguarantors. Finally, as a remedy to the guarantor in advance of his making good the principal debtor's default, he may seek (4) exoneration. These remedies are explained in sec. 1703.

1705. AI May 1937 (8). Roberts was indebted to Peters and had given Peters certain securities to hold as collateral. At Peters' insistence, Roberts procured and gave to Peters a surety bond guaranteeing the payment of this debt, but the surety company at no time prior to default by Roberts knew that Roberts owned these securities or that Peters held them as collateral. After the surety company had been compelled to pay Roberts' debt to Peters, could the surety company utilize these securities in proceeding against Roberts, and if so, by virtue of what principle?

The surety company may be subrogated to these securities (secs. 930 and 1703). The surety's right of subrogation in respect to collateral is not dependent upon his prior knowledge of its existence.

1706. NY Oct. 1943 (13). (a) In connection with the law of guaranty and suretyship, to whom do the following words apply: (1) contribution, (2) indemnification, (3) exoneration, (4) subrogation?

(b) Give a brief definition of each of the four terms.

(a) (1) Contribution applies as between cosureties, (2) indemnification as between a surety and the principal, (3) exoneration as between a surety on the one hand and the principal and creditor on the other (to compel payment by the principal

to the creditor), also by a surety as against his cosureties, and (4) subrogation as between the surety and the creditor.

(b) See secs. 930-933 and sec. 1703.

1707. AI-NY Nov. 1945 (10). (a) Allen and Bell are cosureties on a debt of Covey to Dixon for \$12,000. Covey fails to pay. Allen is compelled to pay Dixon \$8000 in partial payment of the debt. Allen sues Bell, his cosurety, for \$4000 contribution. Can Allen recover \$4000 from Bell? State your reason.

(b) Define and distinguish between a suretyship, a guaranty, and an indemnity.

(a) Allen can recover no more than \$2000 from Bell. When two or more guarantors are jointly and severally obligated on a guaranty, each guarantor, upon paying more than his proportionate share of the guaranty, may compel the co-guarantor or coguarantors to contribute their respective shares of the excess, but in no case can the surety seeking contribution recover more than the excess he has paid beyond the amount which, as between himself and the cosureties, it was his duty to pay. (See sec. 933.)

(b) See secs. 904 and 1689, subds. (a) and (b).

Suretyship or guaranty v. indemnity. The object of a contract of guaranty is to induce the extension of credit. The object of an indemnity agreement is to assume, for a money consideration, the risk of loss if credit is extended. (For further distinction, see sec. 906.)

CHAPTER X-A

Insurance

1708. NY Oct. 1937 (10) ; NY Nov. 1930 (5). What constitutes an insurable interest in property? Illustrate.

In general, a person has an insurable interest in the subject matter insured where he has such a relation or connection with it or concern in it that he will derive pecuniary benefit from its preservation and will suffer pecuniary loss or damage from its destruction, termination, or injury by the happening of the event insured against.

For example, if *A* takes out a policy of rain insurance, requiring the insurer to pay him \$50,000.00 if it rains on a certain day, he will be unable to recover on such policy unless he can show that he had an insurable interest in the weather, that is, that he would derive pecuniary benefit from the absence of rain and would sustain a pecuniary loss or damage from its presence.

1709. AI Nov. 1943 (9). (a) What constitutes an insurable interest in property?

(b) What is credit insurance?

(c) *A* owes *B* \$500. *B* takes out a policy of \$5000 insuring the life of *A*. Subsequently *A* pays the loan in full but *B* continues the policy. Is it valid? Explain.

(a) See sec. 1708.

(b) Credit insurance protects against loss in connection with credit risks, that is, loss sustained in extending credit.

(c) The policy is valid. See sec. 1710.

1710. NY Oct. 1936 (8). *A* owes *B* \$5000. *B* takes out a policy of \$5000 insuring the life of *A*. Subsequently *A* pays the loan in full but *B* continues the policy. Is it valid? Explain.

The policy is valid. It is not necessary, in the case of life insurance, that insurable interest exist at the time of death. This is the rule in the majority of states. Some policies require that an insurable interest continue throughout the life of the policy, and a few states have adopted statutes to that effect. (See sec. 951 subd (b).)

1711. AI May 1942 (12). *X* owed *Y* \$15,000 for which *Y* held as security a mortgage on real property owned by *X*. As further security, and with *X*'s approval, *Y* insured the mortgaged property and also insured *X*'s life. Later, *X* paid his debt in full and the mortgage was duly canceled.

(a) Can *Y* thereafter continue the insurance on the property and collect from the insurance company in the event of loss?

(b) Can *Y* thereafter continue the life insurance and collect from the insurance company upon *X*'s death?

(a) *Y* cannot collect on the property insurance in the event of loss. In the case of property insurance, if there is no insurable interest in existence at the time of the loss, there can be no recovery. (See sec. 951.)

(b) *Y* may continue the life insurance and collect upon *X*'s death. In the case of life insurance, the insurable interest need not exist at the time of the death or loss. (See secs. 951 and 1710.)

1712. NY Oct. 1941 (10). (a) May a corporation have an interest in the life of an officer sufficient for it to take out insurance on his life?

(b) Explain briefly your answer to the foregoing.

(c) How would you advise the corporation to treat the premiums it would pay on such a policy?

(d) Explain fully your reasons for such advice.

(e) May a corporation keep such a policy in force after the officer has retired or been removed?

(a) A corporation has an insurable interest in the life of an officer on whose efforts the success of the corporation's business depends (sec. 949).

(b) Since the corporation stands to gain by the continuance of such officer's life and to lose by his death, it necessarily has an insurable interest in such life (sec. 948).

(c) I would advise the corporation to treat the premiums partly as an asset and partly as an expense.

(d) A substantial part of each premium payment must be set aside by the insurance company as a reserve, available in case the policyholder desires to take advantage of his nonforfeiture privileges (sec. 987). This reserve supplies a cash surrender value to the policy. To this extent, premium payments represent an investment rather than an expense and should be treated as an asset. Except for such reserve, the premium payments should be treated as expense. (Taxwise, such expense would not be deductible, since the proceeds of the policy upon death of the officer would not be taxable as income.)

(e) The authorities are not in accord on the question of whether a corporation may keep such a policy in force after the officer has retired or been removed. The courts in some states hold that a corporation may continue such policy under the general rule that in the case of life insurance it is not necessary that there be an insurable interest at the time of the loss.¹ The courts in other states hold the termination of an insurable interest in such cases fatal to the validity of the policy.²

1713. AI May 1941 (5). (a) Define insurable interest with respect to (1) life insurance, and (2) property insurance.

(b) If the insured sells a building on which he has procured fire insurance and the sale price includes the proper amount for unexpired insurance, is the buyer thereby legally entitled to hold the insurer for a loss during the term of the policy?

(c) Has an unsecured creditor an insurable interest in the property of his debtor?

(a) (1) If a person is so related to another by blood, marriage or business, as to justify a reasonable expectation of benefit or advantage from the continuance of the latter's life, and loss or detriment from its termination, he has an insurable interest in such life. (See sec. 949.)

(2) A person has an insurable interest in property when he has such right, interest or relation to it that he will be benefited by its preservation and continued existence, and will suffer a direct pecuniary loss from its destruction or injury by reason of the peril insured against. (See sec. 950.)

(b) The buyer is not legally entitled to hold the insurer for a loss under the facts stated, since he could acquire no right, by assignment, to a personal contract between the seller and the insurance company, unless such assignment were consented to by the insurer. A fire insurance policy does not "run with the land." (See secs. 975 and 1717.)

(c) An unsecured creditor has no insurable interest in the property of his debtor. The creditor's claim constitutes

¹ Florida (*McMullen v. St. Lucie County Bank*, 128 Fla. 745); Georgia (*Chapman v. Lipscomb-Ellis Co.*, 194 Ga. 640); Iowa (*Reilly v. Penn M. L. Ins. Co.*, 201 Iowa 555); Kansas (*Sinclair Ref. Co. v. Long*, 139 Kan. 632); Tennessee (*Wurzburg v. New York L. Ins. Co.*, 140 Tenn. 59).

² Missouri (*Baker v. Keet-Rountree Dry Goods Co.*, 318 Mo. 969); North Carolina (*Victor v. Louise Cotton Mills*, 148 N.C. 107; *American Tv. Co. v. Life Ins. Co.*, 173 N.C. 558); Texas (*McBride v. Clayton*, 140 Tex. 71, 166 S.W. (2d) 125).

merely a personal right against the debtor. Not until the creditor has reduced such right to a specific lien, as by a duly docketed judgment against the debtor (sec. 1144), does the creditor have a sufficiently identifiable right in respect to such property to serve as a basis for an insurable interest.

1714. NY Apr. 1944 (2). A woman past middle life is partly dependent upon a younger brother who is reputed to be rich and who owns several properties including the house which she occupies rent free.

(a) Does she have an insurable interest whereby she can take insurance upon the life of her brother or upon the house against loss by fire?

(b) Explain.

(a) The facts support an insurable interest in the brother's life, but not in the house.

(b) In the case of the brother's life, a mere expectation of benefit, though without legal right, is sufficient. In the case of the house, there is neither legal right, nor expectation founded on legal right. See sec. 951, subd. (a).

1715. NY Apr. 1939 (10). (a) May a fire insurance policy be assigned?

(b) May a life insurance policy be assigned?

(c) What is meant by the alienation clause in an insurance policy?

(a) A fire insurance policy is not assignable, since it involves a personal relationship based upon the assured's character, habits, experience and background. (See sec. 975.)

(b) A life insurance policy may be assigned, the same as any other *chose in action*. It differs from a policy of property insurance in that the loss insured against is one that is certain to happen. It should be noted, however, that practically all life insurance policies contain a clause to the effect that no assignment shall take effect until written notice thereof has been given to the company. (See sec. 992.)

(c) The alienation clause in an insurance policy is a clause in the standard fire policy which voids the policy upon a change of interest in the property insured. The language commonly employed is that "This entire policy, unless otherwise provided by agreement, indorsed hereon, or added hereto, shall be void if any change other than by the death of an insured take place in the interest, title or possession of the subject of insurance (except change of occupants without increase of hazard), whether by legal process or judgment, or by voluntary act of the insured or otherwise."

1716. NY Apr. 1940 (14). (a) May a fire insurance policy be assigned by the insured?

(b) What is the effect of a sale of insured property? Explain.

(c) Define reinsurance.

(d) How does reinsurance affect the insured?

(a) See sec. 1715, subd. (a).

(b) Upon the sale of insured property, the seller ceases to have an insurable interest, and his contract with the insurer is automatically terminated. The buyer can acquire no rights under the seller's policy of insurance unless such rights are duly assigned with the consent of the insurance company. See secs. 975 and 1713, subd. (b).

(c) Reinsurance is insurance by which one insurer is protected by another insurer in connection with a risk already assumed by the first insurer.

(d) The effect of reinsurance upon the insured depends upon the terms of the contract of reinsurance. Three types of relationships may be created by such contract:

(1) The contract of reinsurance may be solely between the insurer and the reinsurer for the purpose of indemnifying the insurer against losses insured by the latter. In such cases the insurer's policyholders have no interest in the contract of reinsurance and are not affected by it.

(2) The contract of reinsurance may contain a provision whereby the reinsurer binds himself to pay any loss that may be sustained by the insurer's policyholders for which the insurer would be liable. Such an obligation from the reinsurer to the insurer for the benefit of the insurer's policyholders falls within the Third Party Beneficiary Rule (sec. 200) and gives the policyholders a direct claim against the reinsurer.

(3) Some contracts of reinsurance constitute a novation (sec. 212) whereby the reinsurer, in effect, is substituted for the insurer and becomes directly liable to the insurer's policyholders.

1717. NY Apr. 1936 (3). Smith recently purchased improved real estate. He shows you an unexpired fire insurance policy accurately describing the buildings, but payable to the former owner and not assigned or transferred to Smith. He says he is fully protected because the buildings are insured and the policy "runs with the property insured." Is his statement correct? Give your opinion.

Smith's statement is not correct. A fire insurance policy being a personal contract, the buyer of insured property acquires no right to the policy by reason of his purchase. A fire insurance policy, unlike a covenant in a deed, does not "run

with the land." See secs. 975, 1713 subd. (b) and 1715, subd. (a).

1718. AI Nov. 1935 (11). (a) What are the principal kinds or types of insurance?

(b) What is the legal reason why insurance is lawful although bets and wagers usually are unlawful?

(c) What is meant by insurable interest?

(d) Give an example of subrogation in relation to insurance?

(e) What is meant by general average?

(a) Among the major types of insurance are life, fire, marine, casualty, fidelity, accident and health, liability, burglary, automobile, title, credit, unemployment, boiler, plate glass, rain and hail, rent, tornado and wind insurance.

(b) Insurance transactions are mutually beneficial. The price paid is measured by the benefit bestowed. The result is a benefit to the community. Bets and wagers are one-sided. One man's gain is another's loss: the money merely changes hands. The result is to discourage productive effort: a detriment to the community. (See sec. 941.)

(c) See secs. 948 and 1708.

(d) See sec. 1002, Examples (1) and (2).

(e) General average relates to a provision in marine policies whereby the underwriter undertakes to average up losses sustained by the owners of cargo which is thrown overboard for the benefit of the ship and the rest of the cargo. By compelling contribution from the owners of the vessel and cargo saved, for the benefit of the owners whose cargo was lost to save the others, a general average is established. (See sec. 966.)

1719. NY Oct. 1935 (4). Define each of the following types of insurable contracts: (a) fire, (b) casualty, (c) marine, (d) fidelity, (e) employer's liability.

(a) A fire insurance contract is one which indemnifies the insured against property loss by fire.

(b) The term *casualty insurance* is broadly applied to all forms of insurance covering loss or damage resulting from accident or unanticipated contingency, except fire and the elements. (See sec. 994.)

(c) A marine insurance contract is one which protects the insured against marine losses, including fire, shipwreck and piracy.

(d) A fidelity insurance contract is one which protects

against losses from fraud or dishonesty of agents or employees.

(e) An employer's liability insurance contract is one which protects an employer from liability for injuries sustained by his employees during the course of their employment.

1720. AI Nov. 1941 (11). (a) What is the function or purpose of the amount of insurance stated in a fire-insurance policy (other than a valued policy)?

(b) For what reason is an insurer against loss by fire generally given the option to restore or rebuild destroyed property?

(c) In case of dispute as to the meaning of a clause in a fire-insurance policy, in whose favor is doubt generally resolved, and why?

(d) If an accident or health policy does not define total disability, can an insured successfully claim total disability if he is able to earn a living in some occupation which is not his usual and regular one?

(a) The function or purpose of the amount of insurance stated in a fire-insurance policy (other than a valued policy) is to fix a recoverable maximum.

(b) An option to restore or rebuild, in lieu of a cash payment to cover the loss, enables the insurer to protect himself against the necessity of contesting inflated or fraudulent awards. It also tends to discourage arson, which is motivated usually by the prospect of a cash payment.

(c) In case of dispute about the meaning of a clause in a fire-insurance policy, the doubt is generally resolved in favor of the insured and against the company, which drew up the policy. (See secs. 196 (f) and 977.)

(d) The term *total disability*, unless otherwise defined in the policy, means permanent inability of the insured to earn a living at his usual and regular calling. Thus, if a prize fighter loses an arm, he has sustained total disability, though he may obtain other employment.

1721. AI and NY Nov. 1944 (4). (a) In a fire-insurance policy, what does an 80% coinsurance clause mean?

(b) What reason is there for such a clause?

(c) A merchant has a stock of merchandise worth \$10,000, on which he has a fire-insurance policy for \$6000, with an 80% coinsurance clause. Fire destroys \$4000 worth of his merchandise. How much insurance can he recover? Explain.

(d) Is a contract of fire insurance assignable? Explain.

(e) Is it necessary that the person named as beneficiary in a life-insurance policy have an insurable interest in the life of the insured?

(a) A coinsurance clause provides that if the owner will insure his property up to a given percentage of its value (usually

80%), he will be given the benefit of a lower premium, and if he insures for less than the fixed percentage, he must himself bear a proportion of any loss, that is, he must be a coinsurer on such loss. (See sec. 972.)

(b) The standard coinsurance clause is designed to induce owners to insure their property at a higher percentage of its value. The tendency is to insure property at less than its full value, because most fires result in partial loss.

(c) The merchant will recover \$3000. Under the 80% coinsurance clause, the merchant was required to insure the stock for 80% of its value, that is, for \$8000. Instead, he insured the stock for \$6000. He may therefore recover only such percentage of the loss as the actual insurance (\$6000) bears to 80% of value (\$8000); that is, $6000/8000$, or three fourths of the \$4000 loss, namely, \$3000.

(d) A contract of fire insurance is not assignable. (See secs. 975, 1713, subd. (b), 1715, subd. (a) and 1717.)

(e) The person named as beneficiary in a life-insurance policy need not have an insurable interest in the life of the insured. (See sec. 951.)

1722. NY Apr. 1943 (15). The owner of a building which cost and is worth \$50,000, believing that his loss by a fire would not exceed \$20,000, took standard policies with 80% coinsurance clauses in two companies, each for the amount of \$10,000. His loss by a fire was appraised at \$20,000, exactly the amount of insurance he carried.

(a) How much can he recover from each company?

(b) What features of insurance law control in this instance?

(c) Would the value of unexpired insurance be the same in an organization's balance sheet as a going concern and in a realization and liquidation statement of it? Explain.

(a) The owner can recover \$5000 from each company.

(b) The controlling features in this instance are *coinsurance* and *concurrent* insurance (assuming that the policies contained the usual coinsurance and concurrent insurance provisions). Under the coinsurance provision (sec. 972), the owner was required to insure the building up to 80% of its value, and, failing to do so, could recover only such percentage of the loss as the actual insurance (\$20,000) bore to 80% of value (\$40,000), that is, one half of the \$20,000 loss, or \$10,000. Under the *pro rata* clause which applies in the case of concurrent insurance (sec. 973), the insured could collect from each company only its proportionate or *pro rata* share of liability

in the total amount of insurance. (See example in sec. 973.)

(c) The value of unexpired insurance in an organization's balance sheet as a going concern would not be the same as in a realization and liquidation statement of the organization. On a going concern basis, unexpired insurance would be carried on the balance sheet at an amount equal to the proportion of the unexpired period to the total premium period. Thus, if a five-year policy has three years to run, the value of the unexpired insurance on a going concern basis would be three fifths of the total premium paid, on the usual "long-rate" basis. However, on a realization and liquidation basis, the amount recoverable upon cancellation of the insurance would be figured on the "short rate" basis for the shorter term, that is, the premium which the organization should have paid will be figured at a higher rate. (See sec. 975, "Seller's choice as to unexpired insurance.")

1723. AI Nov. 1938 (9). On December 1, 1937, a client procured fire insurance on a small warehouse for three years and paid the premium in advance. He now is about to sell the warehouse. What would you advise him to do with respect to the unexpired insurance?

I would advise the client to assign the unexpired insurance to the purchaser, upon approval and indorsement by the insurance company, which will then issue a new policy to the purchaser. Otherwise, the client would have to obtain credit from the insurance company for the unearned premium, which usually means sacrificing the benefit of a cheaper premium on the "long rate" basis (sec. 1722). By assigning the policy to the purchaser (with the company's consent), the client receives payment from the purchaser of the full value of the unexpired insurance.

1724. AI May 1937 (7). When a mortgage on improved real estate contains no covenant on the mortgagor's part to carry fire insurance for the benefit of the mortgagee:

(a) Can the mortgagor insure for his own benefit?

(b) If so, by what would the amount of legally recoverable insurance be measured?

(c) In the event of loss, has the mortgagee a lien on the insurance proceeds?

(a) A mortgagor, being the owner of the mortgaged premises, may insure them for his own benefit up to the full value of his interest.

(b) The amount of recoverable insurance is measured by

the full extent of the loss, provided the property was insured up to such amount. The insurance company is not entitled to make any deduction for existing mortgage or other liens: Such liens are of no concern to the insurance company.

(c) In the event of loss, the mortgagee has no lien on the insurance proceeds, except by special agreement for such purpose, or by the terms of a policy issued for the benefit of the mortgagee to protect his mortgage lien. (See sec. 950, "Mortgagor and mortgagee.")

1725. NY Oct. 1938 (5). (a) What is a guaranty?

(b) What is a contract of suretyship?

(c) What right has an insurance company to cancel a policy once issued by it and accepted by the insured?

(d) What is meant by the *pro rata* clause in an insurance policy?

(a) See sec. 1689, subd. (a).

(b) See sec. 1689, subd. (b).

(c) An insurance company may by the terms of its policy reserve the right to cancel the policy upon giving notice to the insured and returning the unearned premium to him. Such right may be confirmed by statute, as in the case of the standard fire insurance provision, which requires five days' notice of cancellation to the insured, accompanied by return of unearned premium. "If the insurance company desires to cancel it must, as we have held in the cases cited, not only give the notice required, but accompany it by the payment or tender of the *pro rata* amount of the unearned premium; it cannot legally demand of the insured the surrender of the policy and its cancellation until this is done."³ A similar provision is contained among the standard provisions for accident and health policies. The New York statute, for example, provides⁴ "The insurer may cancel this policy at any time by written notice delivered to the insured or mailed to his last address, as shown by the records of the insurer, together with cash or the insurer's check for the unearned portion of the premiums actually paid by the insured, and such cancellation shall be without prejudice to any claim originating prior thereto."

An insurance company may likewise terminate a policy procured through fraud. Such termination is not, strictly speaking, an act of cancellation, but rather an act of rescission.

³ *Buckley v. Citizen's Ins. Co.*, 188 N.Y. 399, 404.

⁴ *Insurance Law*, sec. 107, subd. 16.

An insurance company may also declare a *forfeiture* of the policy for breach of a promissory warranty, covenant or condition subsequent. Such act of forfeiture is sometimes popularly (though inaccurately) referred to as an act of cancellation.

(d) The *pro rata* clause in an insurance policy provides for an apportionment of liability as between or among several insurance companies on the same risk. It is designed to limit recovery against each company to its ratable proportion of the loss. (See secs. 973 and 1722, subd. (b).)

1726. NY Apr. 1935 (6). Explain the following provisions in life insurance policies: (a) incontestability, (b) grace, (c) nonforfeiture, (d) reinstatement, (e) limitation of action.

(a) The *incontestability* clause of a life insurance policy is a provision to the effect that after a policy has been in force for a given length of time (the most common period is two years), the policy cannot be contested by the insurance company for misstatements by the insured or for any other reason (except those specified in the policy, such as nonpayment of premiums, and so on).

(b) The term *grace* represents an indulgence, as distinguished from a right. Days of grace represent a time of indulgence. Grace may, however, be converted from a favor into a right, as by contract, or by law. In the law of insurance, for example, the compulsory standard life provisions impose a thirty-day grace period for the payment of premiums beyond the actual date on which the premium is due. (See sec. 981.)

(c) *Nonforfeiture* relates to a statutory provision against complete forfeiture by a policyholder of his entire interest in the policy in case he defaults in payment of premiums. The statute provides for certain rights reserved to the insured notwithstanding his default, provided he has paid three full annual premiums. These rights take the form of options to receive back in cash the surrender value of the policy, or to be reinstated upon proof of insurability and upon making good the default within the prescribed period.

Another *nonforfeiture* provision is that which prohibits a life insurance company from declaring a forfeiture without giving written notice at least fifteen and not more than forty-five days prior to the day when the premium is payable. (See sec. 991.)

(d) Reinstatement "implies placing the insured in the same condition that he occupied and sustained towards the insurer next before the forfeiture was incurred."⁵ (See sec. 989.)

(e) The *limitation of action* clause in a life policy is that which provides that no action can be maintained to recover on a forfeited policy of life or total disability insurance, unless it is instituted within two years from the date of default. This does not apply to actions to recover cash surrender value, or the amount of any paid-up or extended insurance.

No other limitation statute appears to be applicable to actions on a life insurance company, except the usual provision relating to ordinary actions on contract. This is not true of other forms of insurance. The standard fire policy clause, for example, provides that no suit shall be sustainable until after full compliance by the insured with all the policy requirements, nor unless the action is commenced within twelve months next after the fire.

1727. AI Nov. 1936 (5). Benson for ten years had held a full-life non-cancellable accident and health policy issued by the Accident Company which provided that all annual premiums must be paid in advance at the home office of the company. The premium for each year had been duly paid by Benson's check mailed to the home office and accepted by the company. Prior to the premium due date in 1936, Benson duly mailed to the company his check for the proper amount, having funds in his bank sufficient to cover it, this check being enclosed in a properly addressed and stamped envelope with a return address, and being mailed in ample time to reach the company's home office one day before the due date. This check was not received by the company nor was it cashed by anyone or returned to Benson. The day after the premium was due, the company canceled the policy and duly notified Benson. Can Benson compel the Accident Company to reinstate the policy by offering a duplicate check immediately upon his receipt of the notice of cancellation?

Under the circumstances, Benson can compel the Accident Company to reinstate the policy.

Ordinarily, when one elects to transmit something through the mails, he thereby designates the mails as *his* agent, and the risk of nondelivery or delayed delivery is on the sender. However, if the sender uses the mails at the request of the receiver, or in response to the latter's offer, the post office is thereby designated as the receiver's agent, and delivery is complete upon deposit in the mails. Hence, if a premium is sent by

⁵ *Black's L. Dic.*, Third Ed., 1520.

mail, nondelivery or delayed delivery is at the risk of the insured, unless the company or its authorized agent requested or directed payment by mail, or unless such payment was impliedly authorized by a long course of conduct acquiesced in by the company. (Secs. 118, 221 and 946.) It would appear that payment in the manner described had been acquiesced in over a long period. Hence, the delayed payment could not spell out a default until Benson had a reasonable opportunity to make good.

1728. NY Oct. 1940 (2); NY Apr. 1942 (4). (a) What is employer's liability insurance?

(b) What is the insurable interest of the employer in a policy of this kind?

(a) Employer's liability insurance indemnifies employers against liability for injuries or accidental death of employees sustained during the course of their employment.

(b) The insurable interest of the employer in this type of risk is the loss which the employer may sustain by reason of his liability toward his employees or (in case of death) their next of kin, a liability imposed by statute regardless of negligence. Moreover, on the basis of ordinary insurance principles, the employer stands to gain by the preservation of life, limb and good health of his employee personnel.

1729. AI May 1936 (8). Martin, a licensed insurance broker, procured a new policy from an insurance company, delivered it to the assured, and collected the premium. He then notified the company that he had collected the premium and the company sent him a bill for the premium payable in sixty days. The policy contained a provision to the effect that the broker was an agent of the assured and not of the insurance company. Martin failed to pay the amount of the premium to the company and thereupon the company sent a notice to the assured canceling the policy for nonpayment of the premium. Must the assured again pay the premium to avoid cancellation of the policy?

The assured need not pay the premium again to avoid cancellation. Any insurance company which delivers a policy to a broker who has requested it on behalf of some insured, is deemed to have authorized the broker to receive on its behalf payment of any premium due on such policy. Even where the policy contains a restriction upon the broker's authority to collect premiums, such provision may be deemed to have been waived by subsequent conduct. (See example in sec. 1006.)

CHAPTER XI-A

Property

1730. NY Apr. 1937 (4). In accounting, property is designated as assets, which are classified as current, deferred, fixed, and so on.

In law, property is otherwise described as of either of two classes, each of which may be of two kinds.

(a) Give the law designations of the two classes of property and of the two kinds of property.

(b) Show the law classes and kinds of *each* of the asset items stated in a balance sheet, as follows:

Current assets

Cash

Accounts receivable

Acceptances receivable

Inventories

Deferred assets

Prepaid lease, six months

Unexpired insurance

Fixed assets

Land

Buildings

Machinery, movable

Leasehold, 21 years

Patents

(a) All property is either *real* or *personal*.

Real property is anything fixed, permanent, and immovable, such as land and things permanently annexed to the land. All other property is *personal*.

All property, whether real or personal, is either *tangible* or *intangible*. (For an explanation of tangibles and intangibles as related to real and personal property, including *choses in possession* and *choses in action*, see secs. 1020 and 1054.)

(b) Current assets:

Cash: *personal; tangible (choses in possession)*

Accounts receivable: *personal; intangible (choses in action)*

Acceptances receivable: *personal; intangible (choses in action)*

Inventories: *personal; tangible (choses in possession)*

Deferred assets:

Prepaid lease, six months: *personal; intangible (chose in action)*

Unexpired insurance: *personal; intangible (chose in action)*

Fixed assets:

Land: *real; tangible*

Buildings: *real; tangible*

Machinery, movable: *personal; tangible (chose in possession)*

Leasehold, 21 years: *personal; intangible (chose in action)*

Patents: *personal; intangible (choses in action)*

1731. NY Apr. 1936 (15). What are fixtures (a) as between vendor and vendee of real estate, (b) as between landlord and tenant? Give an example of each class.

Fixtures are chattels affixed to realty. They are sometimes termed *real fixtures* if attached with a view to permanence, and *chattel* or *personal fixtures* if attached with a view to temporary use, with the right to remove them reserved to the owner of the chattel.

The question as to whether a fixture becomes part of the realty or remains the property of the annexer, depends upon whether or not the annexation was intended to be permanent. Such intent may be *express*, as where specific provision concerning the ownership of the fixture is made in a lease or other contract; or it may be *implied* from the circumstances of the annexation, such as the character of the annexation itself, the purpose of the annexation, its adaptability to permanent use in connection with the premises, or the question as to whether its removal will seriously injure the premises.

Some fixtures are so clearly intended for permanent use that there can be no questioning their nature as real fixtures; for example, the installation of a bathtub.

Other fixtures are so clearly intended for temporary use that there can be no questioning their nature as personal fixtures; for example, machinery used by a tenant in his business.

In many cases, however, it is more difficult to determine the probable intent governing the annexation. In such cases, a different presumption applies (a) as between vendor and vendee, and (b) as between landlord and tenant.

(a) *As between vendor and vendee*, the question usually arises as to whether a given annexation by the vendor was

intended to be permanent. The presumption is that it was, because the owner has a right to permanent use, and any annexations made by him, excepting things that are obviously personal (such as pictures on the wall, carpets in the hall), will be deemed to have been made with a view to permanent use in conjunction with the premises.

(b) *As between landlord and tenant*, on the other hand, since the tenant's use is temporary, the presumption is that any annexations made by him are for temporary use in conjunction with the premises.

"The law presumes that because the interest of a tenant in the land is temporary, that he affixed for himself, with a view to his own enjoyment during his term, and not to enhance the value of the estate; hence, it permits annexations made by him to be detached during his term, if done without injury to the freehold, and in agreement with known usages. The law presumes that because the interest of the vendor of real estate, who is the owner of it, has been permanent, that he has made annexations, for himself to be sure, but with a view to a lasting enjoyment of his estate, and for its continued enhancement in value."¹

1732. NY Oct. 1939 (8). (a) What estates may a person have in real property?

(b) How may title thereto be acquired?

(a) The estates that a person may have in real property may be broadly classified as follows:

(1) As to their duration: *Freehold* and *less than freehold*.

(2) As to present or future possession: *Present* and *future* estates.

(3) As to their absolute or qualified nature: *Absolute* and *conditional* estates.

(4) As to number and connection of owners: *Joint estates*, *estates in common* and *estates by the severalty*.

(5) As to courts of jurisdiction: *Legal* and *equitable (trust)* estates.

(b) Title to real property may be acquired (1) by occupancy, (2) by descent (inheritance), (3) by marriage, (4) by devise (will) and (5) by deed.

(For more detailed comment on the kinds of estates that one may have in real property and the different ways in which such

¹ *Tift v. Horton*, 53 N.Y. 377, 382.

estates may be acquired, see secs. 1027-1034 and 1041-1043, respectively.)

1733. NY Apr. 1943 (12). (a) What is the largest estate or ownership in real property?

(b) Name and describe the lesser present estates in such property.

(c) Define *reversion*.

(d) Define *remainder*.

(a) The largest estate or ownership in real property is an estate in fee simple, representing ownership forever.

(b) The lesser present estates in real property include estates for life, for years, at will, periodic estates, estates by sufferance, and statutory tenancies. (For a description of these estates, see secs. 1027 and 1089-1094.)

(c) A *reversion* is the balance of a fee that goes back or "reverts" to a grantor after the lapse of a particular precedent estate granted by him. (For an illustration, see sec. 1029.)

(d) A *remainder* is the balance of a larger estate that goes to some person other than the grantor after a particular precedent estate expires. (For an illustration, see sec. 1029.)

1734. AI May 1944 (12). (a) What is an estate for life where real property is concerned?

(b) What are the rights and liabilities of a life tenant?

(c) What is a joint tenancy?

(d) What is an estate in entirety?

(e) What is a tenancy in common?

(f) How is partnership realty held? Explain.

(a) An estate for life in real property is one the duration of which is measured by someone's life.

(b) A life tenant may take from the land wood and timber necessary for fuel, current construction and repairs. This right is known as *estovers*; that is, the life tenant has the current use of the land. He is therefore responsible for its current maintenance, including taxes and carrying charges. A life tenant must not commit *waste*, which consists of a permanent impairment in the value of premises, either by positive act ("active waste") or neglect ("passive waste").

(c) A joint tenancy is a joint estate in real property, whether in fee, for life, for years, and so on, wherein two or more persons acquire the same interest together in the same property, at one and the same time, by one and the same title or source of ownership, each having the same degree of interest as the others, and each having the same right of possession

as the others. If one of such owners (joint tenants) dies, his interest automatically passes to the others by *survivorship*, which is the characteristic feature of joint estates or tenancies.

(d) An estate by the entirety is a joint estate held by husband and wife.

(e) An estate or tenancy in common is one held by two or more persons, each having an undivided interest that is not subject to survivorship.

(f) Under the common law and prior to the adoption of statutes modeled on the Uniform Partnership Act, real property owned by a partnership was generally held by the partners as tenants in common. Under the Uniform Partnership Act, a partner's interest in real property owned by the firm gives him an equal right to possess and use such property for partnership purposes. Such right is not assignable without the consent of copartners. Neither is it subject to attachment or execution (sec. 74) except on a claim against the firm. For the same reason, a partner's right in specific property owned by the firm is not subject to dower, curtesy or allowances to widows, heirs or next of kin. (See sec. 663.)

1735. NY Oct. 1941 (4). (a) In regard to real property, compare the terms *joint tenancy* and *tenancy in common*.

(b) Title to real property may be acquired by any of five methods, of which two are not common though not obsolete. Name and describe the three common methods.

(a) See sec. 1734, subds. (c) and (e).

(b) The three common methods by which title to real property may be acquired are: (1) By descent, (2) by devise (will) and (3) by deed.

(1) Title by descent, or inheritance, is the title that a person acquires by reason of the death of another person intestate. The order of distribution of a decedent's property is determined by law where the decedent has not himself directed the disposition of his property by will. (See sec. 1176.)

(2) A devise is a disposition of real property by will. (See sec. 1208.)

(3) A deed is an instrument by which title to real property is conveyed from one person to another during the lifetime of both parties, the former being known as the grantor and the latter as the grantee. (See sec. 1043.)

1736. NY Oct. 1940 (15). (a) Define license in relation to real property.

(b) Define *easement*.

(c) Does a private easement differ from a public easement?

(a) A license is a permission or privilege to use land for a specific purpose. It is not a definite interest in land, hence it may be created by oral permission and revoked at any time. (See sec. 1035.)

(b) An *easement* is a right that one has in the lands of another, either for his own convenience or for the benefit of his own land. (See sec. 1035.)

(c) A public easement is one enjoyed by the public at large, such as the right to use streets or public highways, or the right of navigation and fishing in tidal waters. A private easement is one enjoyed by an individual as such. (See sec. 1036.)

1737. NY Apr. 1942 (11). A corporation needs land on which to construct a new plant. An owner offers a tract that seems to be appropriate at a price and on terms that are satisfactory to the corporation. The parties agree that the corporation may have 90 days in which its engineers may investigate the suitability of the tract and in which its counsel may make an examination of title. Also they agree for reasons mutually satisfactory that, if the decision should be to go on with the proposed purchase and sale, a period of one year is to be allowed to the corporation in which to make a payment of one-half of the purchase price and payment of the other half is to be deferred five years longer. For their mutual protection, the corporation and owner are to execute four documents, one immediately, a second after 90 days and two not later than one year after the expiration of the 90 days.

(a) Name and describe the instrument to be executed at once.

(b) Name and describe the instrument to be executed after 90 days.

(c) Name and describe the two instruments to be executed one year later.

(a) The instrument to be executed at once may be either an option, or an informal contract or binder, to serve until a more formal contract can be drawn up and signed by the parties. (See sec. 1044.)

(b) The instrument to be executed after 90 days is a formal contract of sale that defines fully and specifically the rights and obligations of each of the parties to the transaction. (See sec. 1045.)

(c) The two instruments to be executed one year later are a deed and a purchase money mortgage. The deed is the instrument of conveyance (sec. 1043), and a purchase money

mortgage is one given to secure the unpaid portion of the purchase price. (See secs. 1047 and 1145.)

1738. NY Apr. 1935 (13). Give *two* reasons why deeds, mortgages and other instruments affecting title to real estate should be recorded.

Two reasons why deeds, mortgages and other instruments affecting title to real property should be recorded, are:

(1) Recording the instrument furnishes a permanent public record of a person's interest in the property, so that if the instrument be lost and a copy be unavailable, the public record will serve to establish the interest in question.

(2) Recording the instrument constitutes notice to the public of the interest evidenced by the instrument, so that all possible persons who may subsequently acquire an interest in the same property will acquire it subject and subordinate to the interest recorded. For example, if Smith sells me a house and lot by a deed that I do not record, and then sells the same property to you by a deed that you promptly record, the law—as between you and me—gives you a prior right to the house, and my only recourse is to sue Smith. But had I promptly recorded my deed, such recording would have constituted notice to the world, including yourself, of my interest in the property, and your only recourse, under the circumstances, would be against Smith. Similarly, if Smith, to secure a loan, gives me a mortgage on his house, and then, to secure a second loan from you, gives you another mortgage on the same house that you promptly record, my mortgage will be subject and subordinate to yours, unless you had either actual knowledge of my previous mortgage, by having been informed of it, or else “constructive” knowledge, by reason of the fact that my mortgage was on record when yours was created.

1739. AI Nov. 1940 (10). A certified public accountant, in making his first audit of the books and accounts of a corporation, notes that the assets include a parcel of real property. The secretary of the corporation gives him an abstract of title.

(a) Describe an abstract of title and mention three kinds or types of items that might be found in one.

(b) What use should the accountant make of this abstract?

(a) An abstract of title is a condensed history of the title to the property that is being acquired, so that the purchaser may be assured that his title is good. Such abstract is taken from the public records affecting the parcel that is being sold.

Among the items that may be found in an abstract of title are: (1) Prior conveyances, (2) prior and existing mortgages, (3) wills and records of probate and intestate administration by which rights in real property were acquired, (4) judgments, (5) taxes, (6) mechanics' liens and other charging liens (secs. 1143-1160), (7) bankruptcy, insanity and divorce proceedings affecting the capacity and rights of parties and their title to lands.

(b) Although an accountant would not be qualified, nor should he attempt, to appraise the legal significance of the various items in an abstract of title, he should make use of such items in the light of their interpretation by competent legal counsel to determine at what value the property should be carried on the books of his client for inventory, tax and similar purposes. For example, in preparing an inventory for estate tax purposes, he should be informed on record charges and incumbrances against the property that should be deducted from its appraised or assessed valuation so as to determine the net value on which his client is subject to the tax.

1740. AI Nov. 1937 (6). (a) X, who is 45 years old, leases from a corporation an entire building for a term of 99 years, the lease binding X's estate. Is this lease held by X personal property or real property?

(b) What elements or factors must be found to make a transaction a gift of personal property?

(c) What elements or factors must be found to constitute adverse possession?

(d) Can title to personal property be acquired by adverse possession?

(a) This lease is personal property. (See sec. 1028.)

(b) The essential elements of a gift are: (1) Competency of parties, (2) absence of consideration, (3) voluntary character of transaction, (4) transfer of possession and (5) intent to pass title. (See sec. 1080.)

(c) The elements or factors that must be found to constitute adverse possession are: (1) The possession must be under some claim of right, (2) it must be hostile to the owner, (3) it must be actual, (4) it must be open, visible and notorious, (5) it must be continuous and (6) it must be exclusive. The foregoing elements are in addition to the basic fact of continuous possession for the prescribed statutory period. (See sec. 1041, "Adverse possession.")

(d) Title to personal property, as well as to real property, may be acquired by adverse possession. "The title to a chattel

may be lost by one party and acquired by another by adverse possession for more than the period prescribed, either by the statute providing for title by prescription to personal property, or, in the absence of such a statute, by the statute of limitations relating to the recovery of such property * * * .”² In the language of a leading case:³ “Possession has always been a means of acquiring title to property. It was the earliest mode recognized by mankind of the appropriation of anything tangible by one person to his own use, to the exclusion of others, and legislators and publicists have always acknowledged its efficacy in confirming or creating title. The English and American statutes of limitation have in many cases the same effect, and, if there is any conflict in the decisions upon the subject, the weight of authority is in favor of the proposition that, where one has had the peaceable, undisturbed, open possession of real or personal property, with an assertion of his ownership, for the period which, under the law, would bar an action for its recovery by the real owner, the former has acquired a good title—a title superior to that of the latter, whose neglect to avail himself of his legal rights has lost him his title. This doctrine has been repeatedly asserted in this court.”

1741. NY Apr. 1936 (14). Explain the distinction between surcharging an account and falsifying an account.

“To surcharge means to show the omission for which credit ought to be given, and to falsify means to show the insertion of a wrong charge. This is the distinction between surcharging and falsifying, and these are both distinguished from the opening of an account or a general accounting in that where an account is opened, the whole is unraveled and the account is taken *de novo*, but where liberty is given to surcharge and falsify, the court takes the account to be a stated and settled account and establishes it as such, and the new account is restated on the same principles as before, merely supplying the omitted items proved and omitting the included items disproved.”⁴

² 2 *Corpus Juris Secundum* 884, citing *Merrill v. Bullard*, 59 Vt. 389, 8 A. 157; *Ulmer v. Ulmer*, 53 Ga. App. 417, 186 S.E. 433; *Redmond v. New Jersey Historical Society*, 132 N.J. Eq. 464, 28 A. 2d 189; *Edison Oyster Co. v. Pioneer Oyster Co.*, 22 Wash. 2d 616, 157 P. 2d 302.

³ *Lightfoot v. Davis*, 198 N.Y. 261, 265.

⁴ 1 *Corpus Juris Secundum* 721.

1742. NY Oct. 1937 (11). (a) Define the following: Patent, trademark, copyright.

(b) Under what circumstances, if any, can the United States Government, by its authority in issuing patent rights, appropriate or use a patented invention without compensating the owner of it?

(a) A patent or letters patent is the term used to designate an exclusive governmental grant. Such an instrument, when issued by the United States Patent Office, grants to an inventor, his heirs and assigns, the exclusive right to make, use and sell his invention for a definite period of time.

"A 'trademark' may be defined as a name, sign, symbol, or device which is attached to goods offered for sale in the market so as to distinguish them from similar goods and to identify them with a particular trader, or with his successors, as owners of a particular business, as being made, worked on, imported, selected, certified or sold by him or them. It has been aptly described as the commercial substitute for one's own autographic signature, certifying to the genuineness of the goods to which it is affixed." ⁵

A copyright is the exclusive right to print or otherwise multiply copies of an intellectual production, to publish and sell the same, and to prevent all others from doing so.⁶

(b) The Commissioner of Patents is authorized to grant, without fee, a patent to any officer, enlisted man or employee of the United States Government, except officers and employees of the Patent Office, provided that the applicant in his application states that his invention may be manufactured and used by or for the United States Government for governmental purposes without payment of royalties to the inventor. This stipulation must be included in the patent.

The United States Government may likewise take over and exploit, without compensation to the inventor, any United States patent owned by an enemy alien.

As to all other patents, the rule is the same as that governing property generally: The United States Government may in the exercise of its police power appropriate any invention, or the use thereof, needed for national defense. Such appropriation, however, must be pursuant to the constitutional limitation that no private property may be taken for a public use without just compensation.

⁵ 63 *Corpus Juris* 308-9.

⁶ 13 *Corpus Juris* 945.

For governmental infringement of a patent, a remedy lies in the Court of Claims.

1743. NY Apr. 1935 (14). Define (a) patent, (b) copyright, (c) trade-mark. Is registration of each of these necessary to furnish protection from infringement?

(a), (b) and (c). See sec. 1742, subd. (a).

Registration of a patent is necessary to furnish protection from infringement because a person has no common law property right in an invention. His rights in that connection are dependent on the statute, which requires that the patent be registered.

Registration of a copyright, however, is not essential to protect a person's natural property right to his literary or artistic production. The statute itself⁷ provides that nothing contained in the copyright law "shall be construed to annul or limit the right of the author or proprietor of an unpublished work, at common law or in equity, to prevent the copying, publication, or use of such unpublished work without his consent, and to obtain damages therefor."

Registration of a trade-mark is not necessary to furnish protection for infringement: "Registration confers no right, and limits none; it is a mere procedural advantage depending upon common-law 'ownership' which can exist quite as well without it."⁸

1744. NY Apr. 1937 (9). (a) Define the following: Patent, copyright, trade-mark.

(b) From whom is title acquired or by whom recognized?

(c) Which, if any, may be transferred?

(a) See sec. 1742.

(b) Title to the exclusive right embodied in a patent originates in and is derived from the government, which grants such exclusive privilege. Title to a common law copyright is derived from the fact that a person has a natural property right to his literary or artistic production. Such right may be surrendered in favor of a statutory copyright derived from the United States Government. (See sec. 1742, subd. (b).) Similarly, title to a trade-mark is a natural property right derived from the use of a name, sign, symbol or device attached to goods offered for sale so as to distinguish them from similar

⁷ *U. S. Code Annotated*, Title 17, sec. 2.

⁸ *Waldes, et al. v. International Mfrs. Agency, Inc.*, 237 Fed. 502, 506.

goods and to identify them with a particular merchant or producer. Such right, being a natural property right, is acquired by creation and use and is recognized as all natural property rights are recognized. However, by registration of such right, the owner obtains a procedural advantage in establishing priority of use. (See sec. 1743.)

(c) Patents, being issuable to "the patentee, his heirs or assigns,"⁹ are naturally assignable. Patents "may be granted and issued or reissued to the assignee of the inventor or discoverer; but the assignment must first be entered of record in the Patent Office."¹⁰

"Copyright secured under this title or previous copyright laws of the United States may be assigned, granted, or mortgaged by an instrument in writing signed by the proprietor of the copyright, or may be bequeathed by will."¹¹

"Every registered trade-mark, and every mark for the registration of which application has been made, together with the application for registration of the same, shall be assignable in connection with the good will of the business in which the mark is used. Such assignment must be by an instrument in writing and duly acknowledged according to the laws of the country or State in which the same is executed; any such assignment shall be void as against any subsequent purchaser for a valuable consideration, without notice, unless it is recorded in the Patent Office within three months from the date thereof. The commissioner shall keep a record of such assignments."¹²

1745. NY Oct. 1939 (13). (a) In connection with patents, what is meant by *royalty*?

(b) In what other connection is the term *royalty* used?

(c) What is the descriptive name for the one who holds a patent right?

(a) A *royalty* is the payment or rental to the owner of a patent for the privilege of manufacturing or using the patented device.

(b) The term *royalty* is also used to designate payments made in connection with the following: (1) Copyrighted matter, (2) oil and gas leases, (3) exploitation of lands, mines and minerals.

⁹ U. S. Code Annotated, Title 35, sec. 40.

¹⁰ U. S. Code Annotated, Title 35, sec. 40.

¹¹ U. S. Code Annotated, Title 17, sec. 42.

¹² U. S. Code Annotated, Title 15, sec. 90.

(c) The descriptive name for the one who holds a patent right is *patentee*.

1746. AI Nov. 1942 (12). The following questions relate to our present patent laws:

(a) What in general is patentable?

(b) Who in general can obtain a patent?

(c) What is the term, or duration, of a patent on machinery granted at the present time?

(d) What redress has a patentee against a person who commits infringement?

(a) Any "new and useful art, machine, manufacture, or composition of matter, or any new and useful improvement thereof, not known or used by others in this country, and not patented or described in any printed publication in this or any foreign country, before * * * invention or discovery" of the invention on which a patent is applied for, is patentable.¹³

(b) The first person who has discovered a new and useful art, and so on, and who is not disqualified by reasons of public policy, such as by reason of being an employee of the Patent Office or an enemy alien residing in enemy territory during a state of war, can obtain a patent by complying with the requirements therefor.

(c) The term or duration of a patent on machinery is seventeen years.

(d) If a patent is infringed, a patentee may sue in the United States District Court for an injunction, together with an accounting for profits, and damages. (See sec. 1074.)

1747. NY Oct. 1941 (13). (a) In the United States, what is the maximum life of (1) a patent, (2) a copyright, (3) a trade-mark?

(b) Is registration necessary or permissible in the case of (1) a patent, (2) a copyright, (3) a trade-mark?

(c) Explain briefly your reasons for your answers to (b).

(a) The maximum life of a patent is seventeen years, without right of renewal, and of a copyright, twenty-eight years, renewable for an additional twenty-eight year period. A trade-mark is subject to no limitation, any more than is any other common law property right. However, a certificate of registration of a trade-mark, service mark, certification mark or collective mark (secs. 1069 and 1070) remains in force for only twenty years, subject to cancellation at the end of six years on failure to file required certificate (sec. 1070).

¹³ United States Code, Title 35, sec. 31.

(b) Registration of a patent is necessary; of a copyright and a trade-mark, permissible but not necessary.

(c) Registration of a patent is necessary because an inventor has no common law right to his invention. Registration of a common law copyright or of a trade-mark is unnecessary, since both these rights are common law rights. However, registration of a copyright or trade-mark is permissible for such advantage as may be derived therefrom. In the case of a copyright, registration causes the common law copyright to be superseded by a statutory copyright (see secs. 1069 and 1743); and registration of a trade-mark supplies a procedural advantage (secs. 1069 and 1743).

1748. AI May 1941 (12). A corporation's balance sheet shows "Patents and trade-marks" as a fixed asset, and you as auditor ascertain that this item represents among other things the cost of obtaining one patent at the beginning of the current fiscal year.

(a) What percentage of amortization with respect to this patent would you insist upon for the current year, and for what reasons?

Your analysis of this account shows that it contains also the cost of a trade-mark that has been duly registered in the United States Patent Office and that is being currently used by the corporation.

(b) Upon what factors would you base a recommendation concerning amortization with respect to this trade-mark?

(a) Since the life of a patent is 17 years, the annual percentage of amortization would be approximately 6% or $1/17$ of the cost of obtaining the patent.

(b) The life of a trade-mark being indefinite and without statutory limitation, a recommendation concerning amortization with respect thereto would have to be based upon business rather than legal factors. The cost of obtaining a certificate of registration of a trade-mark, spread over twenty years (sec. 1747, subd. (a)), is relatively nominal.

1749. AI Nov. 1943 (6). As to patents, trade-marks, and copyrights:

(a) (1) Can any interest in any of them be transferred? (2) Which? (3) How? (4) Is any record required? (5) Where? Explain.

(b) What is the life of a (1) patent? (2) Trade-mark? (3) Copyright? And are any of them renewable? Is so, which, and how long?

(c) Of what value is this knowledge to the accountant?

(a) See sec. 1744, subd. (c).

(b) See sec. 1747, subd. (a).

(c) Knowledge in respect to the life of a patent, trade-mark and copyright would be important to an accountant in figuring amortization and valuation.

1750. NY Oct. 1942 (8). (a) May the United States take over a United States patent owned by an enemy alien?

(b) May the United States appropriate a United States patent owned by one of its citizens?

(c) Would the United States be liable for compensation either to the alien or to the citizen owner?

(d) Can there be a situation where the United States might be liable for infringement of a patent?

(a) The United States Government may take over and exploit, without compensation to the inventor or owner, any United States patent owned by an enemy alien.

(b) The United States Government may appropriate a United States patent owned by one of its citizens under the circumstances described in section 1742, subd. (b).

(c) The United States would not be liable for compensation to the citizen owner where such citizen is an officer, enlisted man or employee of the United States Government to whom a patent has been granted with the proviso that the same may be manufactured and used by or for the United States Government for governmental purposes without payment of royalties to the inventor. (See sec. 1742, subd. (b).)

(d) If the United States Government should take over and exploit, without compensation to the inventor, a patent owned by a United States citizen who has not waived his royalty rights as an officer, enlisted man or employee of the United States Government, the United States might be liable for infringement of the patent.' The United States Government cannot be sued, however, without its prior consent. (For governmental infringement of a patent, a remedy lies in the Court of Claims.)

1751. NY Oct. 1938 (11). Patent or other litigation is often referred to a master.

(a) What is usually the reason?

(b) What are the master's duties?

(c) What do you understand by the "theory of confusion"?

(a) Patent and other litigation is often referred to a master for fact-finding purposes. The practice dates back to the early days of English chancery. With the growing pressure of judicial labors imposed by an ever-increasing number of litigants seeking the aid of chancery, the chancellors early developed the practice of referring matters of a detailed or complicated nature to "masters in chancery," thereby freeing the

time of the Court for matters of a more general and purely judicial nature. This practice has been followed in our own state and Federal courts. The person to whom a matter is thus referred occupies a judicial as well as a ministerial status. He is variously said to be "an arm of the Court," a "quasi-judicial officer" and an "assistant to the Court." Depending upon the jurisdiction and the Court, he is variously designated as "master," "referee," "commissioner," "committee" and "auditor."

(b) There is a wide variation in the scope, function and duties of a master or referee, depending upon the courts in which they function, the statute creating the office, the nature of the matter referred and the terms of the decree pursuant to which a matter is referred.

For example, the duties of an attorney designated by the Court to act as referee in a mortgage foreclosure are very different from those of an official referee to whom a matrimonial action may be referred, or of a referee in bankruptcy whose function is closely prescribed by the Bankruptcy Act, or of a master in a patent litigation directed by a decree to take and state an account or ascertain the amount to be recovered. The duties of a master in a patent infringement case are usually prescribed by the terms of the interlocutory decree.¹⁴

"On a reference for an accounting in a patent infringement case, the master is to determine profits and damages arising from defendant's unauthorized manufacture, sale, or use of the patented invention in question, including a reasonable royalty where that measure of damages is applicable, but not increased damages which the court, under statutory authority may award. The master is bound, and the scope of the accounting is limited, by the terms of the interlocutory decree as properly construed. Generally speaking, the only question open for determination on the accounting is the amount to be recovered,

¹⁴ An "interlocutory decree" in a patent infringement suit is an intermediate decree sustaining the contention that a patent has been infringed. The decree directs an accounting to be taken and ascertained by a master, to determine the profits derived by the defendant from the infringement and the consequent damage to the plaintiff. Upon the master's report and the approval thereof by the Court, a final decree and judgment may be had, embodying the amount of the profit derived and the damage awarded in consequence of the infringement.

and no issue can be brought into the accounting unless its object or effect is to aid in determining that question.”¹⁵

(c) The “theory of confusion,” as related to patents, has been stated thus:

“An infringer who has confused infringing and non-infringing profits so that it is impossible to make a mathematical or approximate apportionment or separation of the infringing and the non-infringing profits, is liable to the patentee for all the profits thus wrongfully commingled.”¹⁶ The same author goes on to say:¹⁷ “The effect of the rule of confusion is to place the burden of apportioning profits on the infringer.”

The doctrine of confusion is not limited to patent litigation merely, but involves any merger of the rights of different parties, as in the case of confusion of boundaries, confusion of debts, confusion of goods and confusion of rights and titles.

The rights, duties and penalties arising out of a case involving confusion of goods frequently depend upon the question as to whether such confusion was willful, fraudulent or wrongful, or merely the result of accident, mistake, negligence or consent.

1752. NY Apr. 1942 (10). (a) Define *interest*.

(b) What is *legal interest*? Is it fixed by law in this state?

(c) What is *lawful interest*? Is it fixed by law in this state?

(d) What is *compound interest*?

(e) What is *usury*?

(a) *Interest* is compensation allowed by law or fixed by parties for the use or forbearance of money, or damages for its detention.

(b) *Legal interest* is interest at a rate that the law applies to a debt in the absence of specific agreement.

(c) *Lawful interest* is the maximum that parties are allowed by law to charge.

(d) *Compound interest* is interest upon interest; accrued interest being added to principal and the whole treated as new principal for the reckoning of interest.

(e) *Usury* is taking, or agreeing to take, directly or indirectly, a greater sum for the use of money than that allowed by law.

¹⁵ 48 *Corpus Juris* 402.

¹⁶ Klooster, *Patent Accounting*, p. 371, citing *Westinghouse v. Wagner*, 225 U.S. 604, 620.

¹⁷ At page 377.

1753. NY Apr. 1941 (3). Give three or more reasons that justify charging interest.

The charging of interest may be justified on four grounds: (1) Sacrifice to lender, (2) benefit to borrower, (3) benefit to society and (4) incentive to saving. (See sec. 1059.)

1754. AI and NY Nov. 1944 (8). (a) The law of what place governs the payment of interest?

(b) Is interest allowed on unliquidated open accounts?

(c) Is interest allowed on an "account stated"?

(d) When does interest begin?

(e) When does interest stop? Name three situations or instances.

(a) Ordinarily, a contract, and any interest provisions thereunder, are governed by the law of the place where the contract is made, especially where a contract calling for interest provides for performance in the place where the contract is made. However, where the contract is made in one place and is to be performed in another, the law of the latter place will govern, unless the place of performance was selected for the purpose of evading the law of the place where the contract was made. (See sec. 1061.) If it is not clear from the contract where it was made or to be performed, the law of the place where suit is brought (the law of the "forum") will govern the validity and effect of a provision for interest.

(b) Interest is not allowed on unliquidated open accounts. On such accounts, the amount due at any given time is uncertain. Only when an account becomes liquidated or definitely agreed upon and a due date is established by demand will an account mature and become interest-bearing.

(c) The establishment of an "account stated" (sec. 1056) will clearly start the running of interest at the legal rate (sec. 1060), unless otherwise provided by contract.

(d) Interest begins to run from the time agreed upon by the parties or, in the absence of agreement, from the maturity of the debt and the making of a demand. Some statutes provide for interest from the date the wrong is committed, especially a contract wrong, that is, a breach of contract. (Sec. 1062.)

(e) Interest stops in any of the following situations: (1) on performance, (2) on tender, (3) on impossibility created by war, (4) on impossibility created by creditor, (5) on government order, (6) on deposit in court. (For further explanation, see sec. 1063.)

1755. NY Oct. 1939 (9). (a) What is the legal rate of interest on loans in New York State?

(b) Is there any right of recovery if more than the legal rate is paid by (1) an individual, (2) a corporation?

(c) What liability attaches to an individual who guarantees a corporate contract having more than the legal rate of interest?

(a) The legal rate of interest on loans in New York State is 6% per annum. That is also the lawful rate. (For the distinction between legal and lawful rate, see sec. 1060. For the legal and lawful rates of interest in other states, see the table on pages 532-534.)

(b) There is a right of recovery if the usurious interest rate is paid by an individual, but not if it is paid by a corporation. The most common penalty for usury is loss of all interest. In some states, usury entails the loss of excess interest only. Some statutes prescribe loss of principal and interest, others double and even treble the usurious rate, recoverable by the borrower. (See table on pages 532-534.) Corporations, however, cannot plead usury, and hence can recover no part of usurious interest paid. (See secs. 1066 and 1067, subd. (a).)

(c) An individual who guarantees a corporate contract having more than the legal rate of interest is in no better position than the corporation; he cannot plead usury as a defense. (See sec. 1067, subd. (a).)

1756. NY Apr. 1935 (9). Define *interest*. What effect has usurious interest on a contract? Mention *three* cases in which usury could not be pleaded as a defense.

For a definition of interest, see sec. 1752.

For the effect of usurious interest on a contract, see sec. 1066.

Nine situations in which usury cannot be pleaded as a defense are: (1) Loans to corporations, (2) loans under the Uniform Small Loan Law, (3) loans by special lending agencies and institutions especially authorized by statutes to charge higher rates than those ordinarily allowed, (4) short-term loans by banks and lending agencies on which interest taken in advance constitutes a charge in excess of the legal rate, (5) discount of paper other than the borrower's, (6) charges payable on borrower's default, (7) miscalculation, (8) legitimate service charges and (9) premium for purchase on credit. (For details in respect to these exceptions to the usury laws, see sec. 1067.)

1757. **AI Nov. 1942 (1).** X lends \$5000 to Y, for which Y gives X his written promise to repay the principal in installments of \$1000 per annum.

(a) Would a provision in this agreement whereby Y promises to pay interest at the highest rate permitted by law, compounded annually, be legally valid?

(b) Assume that this agreement contains a promise by Y to pay simple interest annually at 4% per annum. If Y duly pays the first \$1000 on account of principal but pays no interest, would a further agreement executed at that time to add the unpaid interest to the interest-bearing principal be legally valid?

(a) The provision would be invalid. Except where a statute expressly permits it, parties may not contract in advance for the compounding of interest or for the payment of interest upon overdue and unpaid interest installments (sec. 1064).

(b) The agreement would be valid. After interest has accrued, parties may agree to add the accrued interest to principal, thus making a new principal upon which interest is to be computed. (See sec. 1064.)

1758. **NY Oct. 1938 (6).** (a) Define *usury*.

(b) How does usury affect the lender?

(c) Mention *three* exemptions from the operation of the usury law.

(a) *Usury* is the taking or agreeing to take, either directly or indirectly, of a greater sum for the use of money than the lawful interest thereon.

(b) For a general summary of the remedies and penalties for usury, see sec. 1066 and the table on pages 532-534. The penalties for usury and its effect upon the lender are variously prescribed, not only by different statutes in different states but even by different statutes in the same state. For example, various penalties for usury are prescribed by various statutes in New York, as follows:

(1) The *General Business Law*¹⁸ provides for recovery against the usurer of the excess above the lawful rate of interest, provided the action is brought within one year after the payment of the usury. The same statute further provides¹⁹ that all bonds, bills, notes, contracts, securities, and so on, whereby a usurious rate of interest is charged shall be void and a court has the power to enjoin prosecution of any claim thereon and may order the same to be surrendered and cancelled.

(2) A person who makes a usurious charge in connection

¹⁸ Sec. 372.

¹⁹ Sec. 373.

with loans of monies on salaries is guilty of a misdemeanor under the *Personal Property Law*.²⁰

(3) Under the *Banking Law*,²¹ no bank or trust company may charge interest in excess of 6% per annum on any loan or discount made or on any note, bill of exchange or other evidence of debt. However, such legal interest may be taken in advance (sec. 1067, subd. (d).) If a bank or trust company knowingly charges interest in excess of 6%, it forfeits all interest and the person paying the same may recover twice the amount of interest paid, upon suit against the bank or trust company within two years. Banks and trust companies are authorized to operate personal loan departments that may charge interest at a rate not exceeding 12% per annum. Upon advances of money payable on demand in amounts of \$5000 or more, secured by collateral, banks and trust companies may charge any interest upon which the parties may agree.

(4) Taking security upon certain household furniture, sewing machines, plate or silverware in actual use, tools or implements of trade, wearing apparel or jewelry for a usurious loan is a misdemeanor under the *Penal Law*.²²

(c) See sec. 1067 and 1756.

1759. NY Oct. 1935 (13). Define *usury*. State the penalty for usury. Mention the principal exemptions from the operation of the usury law.

For a definition of usury, see secs. 1065 and 1758, subd. (a).

For a discussion of the penalties for usury, see sec. 1066. For a tabulation of such penalties in the different states, see the table on pages 532-534.

For the principal exemptions from the operation of the usury law, see sec. 1067.

1760. AI Nov. 1936 (1). (a) Define *usury*.

(b) What is the general rule of law with respect to usury?

(c) What transactions usually are excepted from the application of this rule?

(d) What are some of the subterfuges adopted in attempts to evade this rule?

(a) See secs. 1065 and 1758, subd. (a).

(b) See sec. 1066 and the table on pages 532-534.

(c) See sec. 1067.

(d) See sec. 1065.

²⁰ Sec. 42.

²¹ Sec. 108.

²² Sec. 2400.

1761. NY Oct. 1942 (12). (a) Define *usury*.

(b) What, if any, are the exemptions from the usury laws?

(a) See secs. 1065 and 1758, subd. (a).

(b) See sec. 1067.

1762. AI May 1939 (6). X purchases on credit an automobile, for which the cash price was \$2100, and agrees to pay \$2400 for it at a date six months after the date of purchase. He makes a payment of \$100 on account and takes possession of the automobile. On the assumption that the legal rate of interest was 6%, can X successfully attack the validity of the contract on the ground of usury?

Assuming good faith and that the transaction was not a usurious subterfuge, X cannot successfully attack the validity of the contract on the ground of usury. "A vendor may fix upon his property one price for cash and another for credit, and the mere fact that the credit price exceeds the cost price by a greater percentage than is permitted by the usury laws is a matter of concern to the parties but not to the courts, barring evidence of bad faith. If the parties have acted in good faith, such a transaction is not a loan, and not usurious. This rule is particularly applicable where the article sold is subject to depreciation in value, as, for instance, an automobile."²³

1763. NY Apr. 1943 (3). An individual holds four notes of solvent debtors each for \$1000, dated October 1, 1941, due October 1, 1942, but differing as to makers and interest. State the value at April 1, 1943, of:

(a) An individual's note with interest at 8% after maturity.

(b) A firm's note with interest at 6% and 8% after maturity.

(c) A corporation's note with interest at 8%.

(d) An individual's note with interest at 8%.

(The above being a New York question, it will be assumed that the notes in question are governed by the lawful rate of interest in New York.)

(a) \$1040. Since the note did not call for interest above the lawful rate until after its maturity, such rate will not be deemed usurious. Interest in excess of the lawful rate, costs of collection, attorneys fees and similar charges payable *on the borrower's default* are not usurious, because the contingency upon which these charges are based is within the debtor's control. (See sec. 1067, subd. (f).)

(b) \$1100. Interest for one year at 6% (a lawful charge) amounts to \$60; interest at 8% for six months *after* maturity (also lawful, see (a)) amounts to \$40; total interest, \$100.

²³ 66 *Corpus Juris* 183.

(c) \$1120. Interest on the note is collectable from its inception, since a corporation cannot plead usury (sec. 1067, subd. (a)). Interest at 8% on \$1000 for 18 months is \$120.

(d) Worthless. The note, calling for a usurious rate of interest, was void from its inception.

1764. NY Oct. 1937 (9). (a) Define *gift*.

(b) Designate the parties to a transaction of gift.

(c) May a gift agreement be made by or be enforced against (1) a bankrupt, (2) a partnership, (3) a municipality, (4) a business corporation?

(d) When is a gift consummated?

(e) May a consummated gift be successfully attacked, and, if so, by whom?

(a) A *gift* is the voluntary transfer, without consideration, of title in and possession of personal property.

(b) The parties to a gift are *donor* (giver) and *donee* (recipient).

(c) A "gift agreement" may not be enforced against anyone, because an agreement to make a gift necessarily implies want of consideration, and a contract wanting consideration is unenforceable. Assuming, however, that the question is intended to inquire into the enforceability of a gift itself, instead of a "gift agreement":

(1) A bankrupt's property is regarded as within the custody and control of the bankruptcy court from the date the petition is filed. Hence any gift made by a bankrupt or alleged bankrupt may be set aside, unless the bankruptcy proceedings are dismissed. The bankruptcy court may enjoin or restrain a prospective bankrupt from transferring his property pending adjudication.²⁴

(2) "Gift of firm property by one partner is not valid as to the other partners' interests if made against the will or without the assent, express or implied, of such co-partners, even though it is binding as to the donor's own interest; hence, the donee may be compelled to account therefor to the nonassenting partners, as a person taking a transfer of firm property from one partner in fraud of the others acquires no title thereto."²⁵ In other words, it is not within the implied powers of a partner to give away partnership property.

(3) A municipal corporation has only such powers as are

²⁴ 8 *Corpus Juris Secundum* 577.

²⁵ 47 *Corpus Juris* 856-7.

contained in its charter. Its functions being purely governmental, and its powers—even when it is engaged in quasi-commercial enterprises, such as water, gas and electric light services—being limited to those that will serve a public purpose, a municipal corporation cannot bind itself by transactions in the nature of gift.²⁶

(4) “Ordinarily, unless created for the purpose, as in the case of charitable corporations, it is not within the power of a corporation to make a gift of its property, however worthy of encouragement or aid the object of the gift may be. This would generally be in violation of the rights of stockholders or members not consenting. But a corporation may dispose of its property without receiving any direct consideration therefor, when such disposition tends to promote a corporate end in a substantial, not in a remote and fanciful, sense. Thus corporations may grant pensions to retiring employees when the result will tend to obtain and retain faithful employees * * *. An apparent gift may, because of peculiar circumstances, be a proper use of the corporate funds. * * * Thus a gift of a sample of its product whereby it is likely that the reputation of the products will receive wider currency, and its sale be increased will be a proper use of corporate property. But a corporation has no power to give away its property when such gift will not result in a benefit to the corporation * * *.”²⁷ In many states, corporations are permitted by statute to make contributions to public benefit organizations, such as the American Red Cross, the USO, and similar organizations, and to receive tax credits therefor.

(d) A gift is consummated by *delivery*, which may be *actual*, as in the case of a physical transfer of possession, or *constructive* (“symbolical”), as by delivering a bank book, bill of lading, or key to a store.

(e) “In general the validity of a gift is a question entirely between the donor and * * * the donee, and it cannot be attacked by a third person having no interest in the property. But at the same time, a person is required to be just before he may be generous, and gifts will not be permitted to stand when the rights of third persons are thereby infringed.”²⁸

²⁶ 44 *Corpus Juris* 75; 63 *Corpus Juris* 177-8.

²⁷ 14 *A Corpus Juris* 528-30.

²⁸ 28 *Corpus Juris* 655.

Example: If Jones, having \$25,000 worth of property, wishes to give it away to his wife, son, or even a stranger, that is his business, and third parties cannot object. But if the gift is made in contemplation of a law suit by a creditor, and if the creditor procures judgment against Jones, he may bring a suit to set the gift aside as a fraudulent transfer.

1765. AI May 1942 (8). (a) Is a promise to make a gift enforceable in law? (Give a legal reason to support your answer.)

(b) How, if at all, can a gift be made of tangible personal property that is so bulky that immediate physical delivery cannot be made?

(c) In what circumstances, if any, can a completed gift of personal property be revoked?

(a) A promise to make a gift is not enforceable. See sec. 1764, subd. (c).

(b) A gift of a chattel that is so bulky and cumbersome that immediate and physical delivery cannot be made, may be consummated by symbolical delivery, as by the delivery of a bill of sale, a bill of lading or the key to a store.

(c) A completed gift of personal property may be revoked in any of the following situations:

(1) Where the donor has been induced to make the gift through force, fraud, duress or undue influence.

(2) Where the gift is conditional and the condition is not fulfilled, as in the case of a gift *causa mortis* (sec. 1081) or a gift made in contemplation of marriage where the engagement is broken off by the donee (sec. 1082).

1766. AI Nov. 1940 (6). (a) Give a simple example of a gift to take effect at death.

(b) Give a simple example of a gift in contemplation of death.

(c) For what reasons, other than a desire to help the donee, are such gifts usually made?

(d) Give a simple example of a gift *causa mortis*.

(a) Any testamentary gift—that is, any disposition of property by will, either outright or in trust—furnishes an example of a gift to take effect on the donor's (testator's) death. Any gift under a living trust (sec. 1222) for the benefit of one person, upon whose death the principal is to go to another person, would furnish an example of a gift to take effect at the death of a person other than the donor. (See sec. 1081, "Gift *causa mortis* v. gift to take effect on death.")

(b) Williams, a wealthy old man in feeble health, makes a gift of all his worldly goods except \$100,000 to his only son.

(See sec. 1081, "Gift *causa mortis* v. gift in contemplation of death.")

(c) Transfers in contemplation of death are frequently motivated by a desire to avoid taxes and the expense and delay involved in the administration and distribution of decedent estates. (See sec. 1081, "Taxability of transfers in contemplation of death.")

(d) For an example of a gift *causa mortis*, see sec. 1081.

CHAPTER XII-A

Landlord and Tenant

1767. NY Apr. 1936 (7). What is a lease? There are six formal provisions usually found in a lease. Name at least four of these provisions.

A lease is a contract whereby, for a consideration called rent, one party agrees to give possession of premises to another. (For a more complete definition, see sec. 1085.)

Among the formal provisions usually found in a lease are the following:

- (a) Provision fixing *term* or *duration* of lease.
- (b) Provision for *rent*: usually that rent is payable in advance on the first of each month during the term.
- (c) *Description of premises* leased.
- (d) Provision specifying *purpose* for which premises may be used.
- (e) Provision for *repairs*: usually (with certain exceptions) that tenant shall make repairs.
- (f) Provision that in case of *destruction or substantial injury to premises* without tenant's fault, tenant may quit and surrender premises.
- (g) Provision covering *fixtures and improvements* annexed to premises by tenant: usually that all annexations by tenant shall become part of premises and shall belong to landlord unless otherwise consented to in writing by landlord.
- (h) Provision for *insurance* (usually confined to long-term business leases and requiring tenant to insure against loss by fire for benefit of landlord).
- (i) Provision for *taxes and assessments* (usually only in long-term business leases, requiring taxes and assessments to be paid by tenant).
- (j) Provision, in the case of *condemnation proceedings*, for disposition of *compensation* received for premises (practically always payable to landlord in case of residence leases; in business leases, either payable to landlord, or apportionable between landlord and tenant—as parties may agree).
- (k) Provision that lease shall be *subject and subordinate* to

all existing and future mortgages. (A lessee for business purposes will be wise to place a limit on the amount of mortgage liens to which the lease shall be subordinated.)

(l) Provision as to *assignment and subletting*: usually that lease shall not be assigned or subleased without landlord's written consent.

(m) Provision covering *liability to third parties* for injuries on the premises (usually that tenant shall indemnify landlord against loss through claims or suits by third parties for injuries sustained on the premises).

(n) Provision for *deposit of security*. (Under the law, all moneys deposited as security by the tenant with the landlord remain the property of the tenant, must not be mingled with other funds of the landlord, and constitute a trust fund in the landlord's hands.)

(o) Provision for *compliance by tenant with all Federal, state and municipal laws*, ordinances and regulations.

(p) Provision that tenant, for default, may be removed by *summary proceedings*, in addition to other remedies available to landlord.

(q) Provision for *quiet enjoyment* of premises by tenant so long as he complies with terms of lease (that is, that by virtue of landlord's paramount title, no other person shall disturb the tenant's right to absolute possession of the premises).

1768. AI and NY May 1945 (10). (a) What is a lease of real property and how is it created?

(b) Name and describe *five* principal provisions of a lease that are of importance to an accountant.

(c) Is an assignee or a sublessee of a lease bound by the terms and covenants of the original lease?

(d) As applied to real property, define license and easement and distinguish between them.

(a) See sec. 1767. A lease is created by contract, express or implied.

(b) The principal provisions of a lease that are of importance to an accountant are:

(1) Provisions for rent, minimum and maximum, with rental acceleration clauses, if any.

(2) Provision for duration of lease, fixing term of tenancy.

(3) Renewal provisions.

(4) Clauses and conditions which may anticipate the ter-

mination of the lease, such as right of landlord to terminate on given notice in case of sale of premises, reconstruction, and so on.

(5) Apportionment of compensation in case property is condemned for a public use.

(6) Provision for deposit of security, and disposition of same.

(7) Provision as to repairs, alterations, and so on, and who is to bear cost thereof.

(8) Provision specifying whether lease is "gross" or "net" (that is, whether rent is inclusive or exclusive of taxes, insurance, water and other overhead charges in connection with the property).

(9) Whether lease is subject and subordinate to mortgage or other liens (as bearing on advisability of tenant's voluntarily incurring expenses for repairs and alterations, in the face of a possible foreclosure which may wipe out his investment in this direction).

(10) Whether fixtures installed by tenant remain assets of tenant or become part of leasehold premises.

(c) An assignee is not personally bound by the terms and covenants of the original lease unless he assumes them; but so long as he remains in possession, he remains bound by the covenants of the lease by virtue of "privity of estate," to the extent that these covenants "run with the land." See sec. 1114, subd. (3).

A sublessee is liable only to the lessor on the sublease, that is, to the original tenant. See sec. 1114, subd. (3).

(d) See sec. 1134.

1769. NY Apr. 1937 (14). (a) Define lease.

(b) Give the designation of the parties to a lease and describe the relationship of each party to it.

(c) State the principal provisions of a lease that are of importance to an accountant.

(a) See sec. 1767.

(b) The parties to a lease are *lessor* and *lessee*, or *landlord* and *tenant*. The *lessor*, or *landlord*, gives possession of the premises and receives the rent, and the *lessee*, or *tenant*, obtains possession of the premises and pays the rent.

(c) See sec. 1768, subd. (b).

1770. AI May 1943 (1). (a) In order to create the relationship of landlord and tenant, must the subject matter of the tenancy be real property, or may it be personal property?

(b) Name at least five provisions which should be found in a properly drawn lease.

(c) Define, illustrate, and differentiate covenants and conditions in a lease.

(d) X mortgages property to Y and thereafter leases the property to Z. During the term of the tenancy, Y obtains title to the property through foreclosure. How, if at all, does this affect Z's rights and obligations as a tenant?

(a) The relationship of landlord and tenant, from its nature, concerns lands; there can be no *landlord* of personal property.

(b) See sec. 1767.

(c) A covenant is a promise or undertaking, usually under seal, that a person will do or refrain from doing some act. A condition is a circumstance on which the validity or continuance of a contract (in this case, a lease) depends. It may or may not be supported by a promise or an undertaking. (For illustrations of the distinction, see sec. 1118.)

(d) Z's rights and obligations as a tenant are subject and subordinate to any and all mortgages on the premises at the time he signed the lease, provided he had actual knowledge thereof, or constructive knowledge by reason of their being on record. (See sec. 1101.) The mortgage foreclosure wipes out Z's entire interest. However, Z has a claim against X for eviction by mortgage foreclosure (sec. 1101).

1771. NY Apr. 1940 (7). (a) Name the instrument and designate the parties to it under which rent is payable by one party to another on (1) real property, (2) personal property.

(b) Upon death of the landlord of real estate to whom will the rent go that (1) is due at the time of death, (2) will become due after death?

(c) Give reasons for your answers to (b).

(a) (1) The instrument is a lease and the parties are lessor and lessee, or landlord and tenant. (See sec. 1769, subd. (a).)

(2) A transaction by which compensation is paid for the use of personal property is designated in law as a bailment for the hire of use (sec. 479), the parties to which are bailor and bailee. Instruments evidencing such transactions are referred to variously as *chattel lease*, *lease for the hiring of a chattel*, *agreement of lease*, or simply *lease*. Parties to a chattel hiring are also sometimes referred to as *lessor* and *lessee*.

(b) (1) Upon the death of the landlord of real estate, rent due at the time of death would go to the landlord's executor in case of a will, or administrator in case of intestacy, to be distributed in accordance with the will, or the law governing intestacy, as the case may be.

(2) Rent accruing after the landlord's death would go to the new owners of the premises, namely, the devisees under a will (sec. 1208), or heirs in case of intestacy (sec. 1176).

(c) Ownership of premises carries with it the right to collect rent. Upon the death of a landlord, leased premises pass to new owners, devisees in case of a will, or heirs in case of intestacy (subd. (b) above). Such new owners, immediately upon the death of the landlord, become entitled to the rent. However, rent which accrued up to the date of death belongs to the landlord's estate, including all beneficiaries thereunder. (See section 1125).

1772. AI May 1939 (12). A sole proprietor is occupying office space under a legally valid lease which will not expire until three months from today. He is in arrears for four months' rent and is about to vacate the premises. He is in arrears also for the rent of two rooms which he occupies without a lease in a hotel. What principles of law are involved in determining his right, upon immediately vacating both premises, to remove all of his property therefrom?

Since the sole proprietor, as tenant under a lease, has exclusive possession of the office space (sec. 1087), his property located on the premises is not subject to a possessory lien for unpaid rent, except in such states (for example, Florida) as provide for a landlord's lien under the circumstances. However, in respect to the rooms occupied without a lease in the hotel, no such exclusive possession exists on the part of the occupant, and for his unpaid bill, the hotel proprietor may hold the occupant's property on the premises and the occupant may be prevented from removing the same. See sec. 1087, subd. (b).

1773. NY Apr. 1942 (8). (a) Compare or contrast the respective rights against the property of the debtor in the case of (1) a keeper of a boarding-house for an unpaid board bill, (2) a landlord for unpaid rent due from a tenant.

(b) State the effect upon a lease of the death of a tenant.

(c) State the effect upon a lease of the bankruptcy of a tenant.

(d) May a tenant sublet the premises he holds under a lease that does not contain a permission to so sublet?

(a) Unlike a tenant, a boarder and lodger *occupy*, but do not *possess* the rooms they hire; possession is in the proprietor. Hence, for an unpaid bill, a hotel proprietor or a boarding-house keeper may hold a guest's or boarder's trunk under a *possessory lien* (sec. 1136); but a landlord, lacking possession, has no possessory lien, hence no right to hold a tenant's property for unpaid rent, except where the common law remedy of "distress" (sec. 1104) is still recognized.

(b) The death of a tenant automatically terminates an agency at will, but not a periodic tenancy, nor a tenancy for years (secs. 1090-1093), unless the lease so provides. Hence, when a tenant dies before the expiration of a lease for a fixed term, his estate is liable for the rent, which becomes a debt chargeable against estate assets.

(c) Upon the bankruptcy of a tenant, in the absence of a provision in the lease as to bankruptcy, the tenant's right to possession under the lease passes to the trustee in bankruptcy. However, leases frequently contain forfeiture provisions to the effect that upon the tenant's bankruptcy, insolvency, and so on, the lease shall automatically terminate. Under such a clause the lease automatically terminates upon bankruptcy, unless the provision is to the effect that the lease shall terminate *at the landlord's option*, in which event such option may or may not be exercised by the landlord. (For a further discussion of this subject, see sec. 1335.)

(d) A lease need not contain express permission to sublet the premises. In the absence of a prohibition against subletting, the tenant has the right to sublet all or any part of the premises.¹

1774. NY Apr. 1939 (12). (a) What is the nature of an estate in land created by a lease?

(b) State *five* ways in which a lease may be terminated.

¹ *Granite Trust Bldg. Corporation v. Great Atlantic & Pacific Tea Co.*, D.C. Mass., 36 F. Supp. 77; *Peters v. Pilcher*, 211 Ala. 548, 100 So. 902; *M. Friedman & Co. v. Sterling Furniture Co.*, 140 Cal. App. 685, 35 P. 2d 1064, 1065; *Newfield Bldg. Co. v. Mohican Co.*, 105 Conn. 488, 136 A. 78; *Edelman v. F. W. Woolworth Co.*, 252 Ill. App. 142; *Magnolia Petroleum Co. v. Carter*, La. App., 2 So. 2d 680; *Patterson v. Butterfield*, 244 Mich. 330, 221 N.W. 293, 296; *Public Service Co. of New Hampshire v. Voudoumas*, 84 N.H. 387, 151 A. 81; *Butterick Pub. Co. v. Fulton & Elm Leasing Co.*, 132 Misc. 366, 229 N.Y. Supp. 86; *James H. Herron Co. v. Jones*, 28 Ohio App. 190, 162 N.E. 624; *Darden v. White* (Tex. Civ. App.), 195 S.W. 2d 1009.

(a) A lease creates a *less than freehold estate*, which is usually associated with the idea of *possession* rather than *ownership*. Originally, under the feudal system, all land tenures, or estates, were either *freehold* (those allotted to freeholders, or freemen), or *less than freehold* (those allotted to the serfs for use and possession rather than by way of ownership). Since a freeholder's interest identified him with ownership of the soil, his interest was (and still is) regarded as *real*; whereas a less than freeholder's interest being temporary and impermanent, was (and still is) regarded as *personal*.

(b) *Seven* ways in which a tenancy may be terminated are:

(1) *By expiration of lease*. In the absence of provision to the contrary, a tenancy is automatically terminated upon expiration of the lease.

(2) *By forfeiture*. A tenant may forfeit his rights under a lease by violation of its terms (for example, by failing to pay rent, or by using it for a prohibited purpose).

(3) *By eviction*; that is, by some act which the landlord has committed (actual eviction), or by some condition which the landlord has permitted (constructive eviction), which forces the tenant out of possession.

(4) *By condemnation*, where premises are condemned for public use under the right of *eminent domain*.

(5) *By destruction or substantial injury to premises*, as by fire or otherwise.

(6) *By surrender*, or mutual agreement between landlord and tenant to extinguish the tenancy, followed by a repossession of the premises on the part of the landlord.

(7) *By operation of law*, as by death in the case of a tenancy at will.

1775. NY Apr. 1944 (5). (a) If the lease does not contain a provision as to repairs, state whether the landlord or the tenant must make and pay for repairs such as the following:

- (1) Redecorating, etc. on a detached dwelling.
 - (2) Redecorating, etc. on a flat in a tenement house.
 - (3) A burst water pipe in a building occupied by one tenant.
 - (4) A subsidence of the foundation wall of the premises.
 - (5) A replaced stairway in an apartment house.
 - (6) A replaced stairway where upper floors are all for one tenant.
- (b) What is the general rule as to repairs?

(a) In the absence of a provision in the lease for repairs, the duty to make and pay for repairs is upon the tenant, except

where the statute provides otherwise. Exceptions to this rule are set forth in sec. 1108. The rule and exceptions may be illustrated as follows:

(1) *Redecorating, and so on on a detached dwelling.* Tenant must make repairs.

(2) *Redecorating, and so on on flat in tenement house.* Duty is upon landlord by statute.

(3) *Burst water pipe in building occupied by one tenant.* Tenant has complete control of premises; duty of repairing pipe is upon him. Water pipe is not "structural."

(4) *Subsidence of foundation wall.* This is a structural repair. Landlord has duty of making structural repairs unless otherwise agreed in the lease.

(5) *Replace stairway in apartment house.* Structural; duty of repair would be upon landlord even if the stairway were not structural, because the landlord has the duty of repairing such portions of premises as are used in common.

(6) *Replace stairway: upper floors are all for one tenant.* Regardless of the fact that the upper floors are all for one tenant, replacing a stairway may be construed as a structural repair. The duty of structural repairs is upon the landlord.²

(b) The general rule as to repairs is that the duty is on the tenant, not the landlord, except where the lease otherwise provides, and except as noted in sec. 1108.

1776. AI and NY Nov. 1944 (9). (a) What classes of fixtures installed or furnished by the tenant are generally held to be removable by the tenant or his representatives?

(b) Within what time must a tenant's right of removal of fixtures be exercised?

(c) Arthur leases land from Baldwin for one year and erects a building on it for business purposes. At the expiration of the year, the lease is renewed for three years. The second lease is in writing and does not mention the building in any way. Before the expiration of the second lease, Arthur, desiring to terminate his tenancy, wants to know his rights to remove the building. Has Arthur the right to remove the building? Explain.

(a) Trade fixtures installed by a business tenant and ornamental fixtures by a residence tenant are generally held to be

²Building codes generally regard stairway alterations as structural rather than ordinary repairs. For example, the Building Code of the City of New York provides that "Ordinary repairs to buildings or structures . . . shall not be construed to include . . . the removal, change or closing of any stairway. . . ."

removable by the tenant or his representatives. See sec. 1110 for further comment.

(b) "One having the right of removal of a fixture has a reasonable time from its accrual within which to exercise such right. A reasonable delay in exercising the reserved right to remove fixtures does not show an abandonment of such right, but an unreasonable delay in exercising the right may result in its loss."³ What constitutes a reasonable time within which to remove a fixture is necessarily a question of fact in each case. Under the earlier decisions, a tenant was required to remove personal fixtures upon termination of his lease, or, in case of a tenancy at will, upon quitting the premises. This is no longer the rule.

(c) Arthur has the right to remove the building. Although buildings attached to land are ordinarily regarded as real property, such is not the case when the building is erected by one not the owner, with the owner's consent, on lands of the latter, in connection with some right granted by the owner, such as a leasehold or similar interest. In such cases the term *personal property* has been held "to include a building which has been sold and is being removed . . . structures constructed upon the land of another . . . and generally things which have been annexed to the realty, but which may be detached or removed under the law relating to fixtures."⁴ Formerly the renewal of a lease by a tenant under the circumstances of this case was held to spell out a waiver of the tenant's property right in the building, on the theory that by leasing the premises with the building on it, he impliedly waived ownership in the building. This view is not reflected in the later decisions. If a building is erected on land with the owner's permission, an agreement is implied that it remains the property of the builder in the absence of circumstances clearly showing a contrary intent.⁵

1777. **AI Nov. 1942 (4).** The owner of a garage mortgaged it and thereafter installed a refrigeration machine in order to use the building in the wholesale beer business in which he then engaged. The machine and its coils could be removed without damage to the building, and thus the building could be restored to its condition as of the date of the mortgage.

³ 36 *Corpus Juris Secundum* 960.

⁴ 50 *Corpus Juris* 760-761, citing numerous cases from different jurisdictions throughout the country.

⁵ *Williamson v. Pye* (Tex. Civ. App.), 18 S.W. 2d 707.

In the absence of an express provision in the mortgage, state whether the lien of the mortgage covered the machine and its coils, giving reasons for your opinion.

The lien of the mortgage would probably be construed as covering the machine and its coils. Although these could be removed without damage to the building, the installation was made for the purpose of converting a garage into a building to be used in the wholesale beer business. Such installation was made by the owner himself. This indicates an intention to make the annexation permanent. "We think that, considering the manner in which the Frigidaire system was installed, the intention of the party who installed it (he being an owner), the damage that would be caused to the realty by moving it, and the adaptability of the fixture to the real estate, the Frigidaire system became a part of the real estate, and that the order appealed from should be reversed."⁶ The Frigidaire case would seem to be on all fours with the present case, except for damage to the premises caused by removing the fixture. Regardless of this difference, in the absence of an agreement or statute to the contrary, fixtures annexed by the mortgagor after the mortgage is given are subject to the mortgage.⁷

1778. NY Apr. 1943 (5). What provisions of a ten-year lease should govern a tenant in deciding upon the period during which he should set up reserves for depreciation of equipment and machinery which he has installed in the premises? Explain.

If a fixture is removable, it constitutes a fixed or permanent asset (except for depreciation). If it is not removable, but becomes the property of the landlord on termination of the lease, it represents (to the tenant) a diminishing or wasting asset. It would therefore be important to examine the ten-year lease to determine whether there is a provision therein which makes equipment and machinery installed on the premises a part thereof, or whether the tenant reserves the right of ownership therein. If the lease contains an option of removal of such installation, or a provision under which the tenant retains title in the machinery and equipment, the tenant's reserves for depreciation will be governed by physical rather than legal considerations. If the lease makes the installation

⁶ *Dolan v. Doherty, et al.*, 242 App. Div. 671, 272 N.Y. Supp. 892, modified 242 App. Div. 897, 275 N.Y. Supp. 1004.

⁷ *In re Taylor & Dean Mfg. Co.*, C.C.A. Pa., 136 F. 2d 370; *General Heat & Appliance Co. v. Goodwin*, 316 Mass. 3, 54 N.E. 2d 676.

in question a permanent one under which the tenant loses his ownership at the end of the lease, he should set up reserves for depreciation of the machinery and equipment as a wasting asset whose value to him is nil at the end of the lease.

The presence or absence of an option of renewal would of course have an important bearing upon the reserves for depreciation to be set up by the tenant.

1779. NY Oct. 1940 (9). (a) Does the death of a lessee terminate a lease?

(b) What is known as the right of distress?

(c) By whom is it invoked and what right does it involve?

(a) See sec. 1773, subd. (b).

(b) The right of distress is the common law remedy given to a landlord to seize movables found on premises where rent is in arrears, and to hold them until the rent is paid. This right has been abolished in most jurisdictions. (See sec. 1104.)

(c) The right is invoked by the landlord, and it involves the landlord's right to assert a lien on the tenant's property located on the premises.

CHAPTER XIII-A

Liens

1780. NY Apr. 1935 (4). Define (a) lien, (b) judgment, (c) mortgage, (d) mechanic's lien.

(a) A lien is a charge imposed on property by which the property is made security for the discharge of an obligation.

(b) A judgment is a formal adjudication of a court after a trial or hearing. Upon being "docketed," or filed, it constitutes a lien against the judgment debtor's real property, but not against his personal property unless execution has been issued (secs. 73 and 1144).

(c) A real estate mortgage is defined as "the conveyance of an estate by way of pledge for the security of a debt, to become void on payment of it" (sec. 1145). A chattel mortgage is a conditional transfer of title to personal property to secure the discharge of some obligation.

(d) A mechanic's lien is the charging lien (sec. 1143) of a contractor, subcontractor, laborer or material man who performs labor or furnishes materials for the *permanent* improvement of *real property*, with the consent or at the request of the owner, or of his agent, contractor or subcontractor (sec. 1159).

1781. NY Oct. 1939 (12). (a) Distinguish between lien and pledge.

(b) As against the owner, what rights has a factor for amounts due?

(c) Discuss the rights of a building contractor for amounts due from the owner.

(d) Has a building contractor any lien on insurance proceeds received by the owner?

(a) A lien differs from a pledge in two respects: (1) liens do not always depend on the transfer of possession, but pledges do; and (2) in a pledge, possession is transferred for the purpose of security, whereas in a lien, possession is not transferred for the purpose of security, but for the hire of some service, and security is not the purpose of the transfer, but only an incidental result, to secure payment for the services rendered. (See secs. 473 and 1129.)

(b) Factors are generally given a lien by statute on merchandise shipped to them, to the extent of any advances made by them to persons in whose names the shipments are made. Such statutes are designed to protect factors who finance or help to finance shipments of merchandise. The factor may reimburse himself for the amount of his lien by pledging or disposing of the merchandise for such purpose.

(c) A contractor, subcontractor, laborer or material man who performs labor or furnishes materials for the permanent improvement of real property, with the consent or at the request of the owner, or of his agent, contractor or subcontractor, has a lien for the principal and interest of the value or the agreed price of such labor or materials upon the real property improved, from the time of filing the notice of such lien in the office of the county clerk or other public filing place designated by statute.

(d) A building contractor or subcontractor has a lien on the proceeds of insurance received by the owner of premises destroyed or removed by fire or casualty, to the extent of such contractor's lien. Material men and workingmen are likewise protected as to insurance moneys received by a contractor or subcontractor.

1782. NY Oct. 1938 (9). (a) Define or illustrate a nonpossessory lien.

(b) Mention *four* types of possessory liens.

(a) A *nonpossessory* lien is one not dependent on possession. Such a lien is more commonly designated as a *charging* lien. Every lien is a charge imposed on property by which the property is made security for the discharge of some obligation. However, the person in whose favor the lien is created (*lienor*) may or may not have possession of the property subjected to the lien. When he does have such possession, the lien is said to be *possessory* (see subd. (b), following, for illustrations). When the lienor does not have such possession, the lien is said to be *nonpossessory* or *charging*. Charging liens, as a rule, are imposed on real, rather than on personal property, because in the case of real property, possession in the lienor is not so important for his protection, since real property is fixed and immovable, and a public record of the lien against it is sufficient to protect the lienor's rights. Illustrations of charging liens are (1) judgments, (2) mortgages, (3) mechanics' liens, and (4) tax liens.

(b) *Six* types of possessory liens are:

(1) *Vendor's* lien (exercised by a seller who, though he parts with title, retains possession pending payment of the purchase price).

(2) *Artisan's* lien (giving one who has bestowed labor or services upon a chattel, the right to retain it in his possession pending payment for the work done, as in the case of a watchmaker, machinist, garage mechanic or garment maker).

(3) *Common carrier's* lien (whereby a common carrier, for the service of transportation, may retain possession of the goods transported pending payment of transportation charges).

(4) *Warehouseman's* lien (by which one who stores merchandise for the owner may retain possession of it until the storage charges are paid).

(5) *Innkeeper's* lien (whereby possession of a guest's personal belongings physically on the innkeeper's premises may be retained by the innkeeper pending payment of the hotel bill).

(6) *Agent's* lien (as, for moneys advanced or expenses incurred on behalf of the principal by a factor or commission merchant in connection with the sale of the principal's goods, which gives such agent a lien either on the goods, or their proceeds; or, the lien of an attorney-at-law on his client's papers pending payment of the fee).

1783. NY Apr. 1937 (10). (a) Name the classes of liens that may attach to real estate.

(b) Describe briefly a lien of each class.

(a) The classes of liens that may attach to real estate are: (1) judgments, (2) mortgages, (3) mechanics' liens, and (4) tax liens.

(b) (1) *Judgments*. See sec. 1780, subd. (b).

(2) *Mortgages*. See sec. 1780, subd. (c).

(3) *Mechanics' liens*. See sec. 1780, subd. (d).

(4) *Tax liens*. A tax lien exists in favor of a governmental authority for the purpose of securing the payment of taxes. A person who buys property on which taxes have not been paid, buys it subject to a lien for unpaid taxes. If, therefore, taxes are due on May 1st and I sell you real property on April 1st, you should secure an offset from the purchase price of an amount which will represent the amount of taxes which have accrued during the time I was the owner, so that when you pay

the tax on due date, you will be paying only for the period after you became the owner. If you do not make such a provision, you will have to pay the tax anyway. If you buy property, your search will include a search for unpaid taxes, which would constitute a lien against the property. If you buy property from a corporation, you will check up to make sure that the corporate franchise tax has been paid, because that would be a lien, also, on property owned by the corporation.

1784. NY Oct. 1935 (11). Name *three* classes of incumbrances on real property. How may they be ascertained?

See sec. 1783. Incumbrances on real property may be ascertained by a search of the appropriate public records in the particular county where the property is located. Systems of filing and recording liens against real property vary in the different states. They follow, however, a fairly uniform pattern. For example, in New York, a title search for incumbrances might include the judgment docket in the county clerk's office, for judgments; the mortgage docket in the county register's office (or county clerk's office in counties which have no register), for mortgages; the mechanics' lien docket in the county clerk's office, for mechanics' liens; the records of the tax department, for tax liens; the records of the surrogate's court, for decedent estate transfers, and so on.

1785. NY Oct. 1942 (9). (a) Define real estate mortgage.

(b) Define chattel mortgage.

(c) Compare filing and recording of mortgages.

(d) Are filing or recording necessary and, if so, in which cases?

(a) See sec. 1780, subd. (c).

(b) See sec. 1780, subd. (c).

(c) To file a mortgage is to place it in official custody; to record it, is to copy it off into a public docket or "liber."

(d) The usual requirement in connection with a chattel mortgage is that it be filed; in connection with a real estate mortgage, that it be recorded.

1786. AI May 1939 (10). Define purchase money mortgage and give a brief example showing circumstances in which one normally would be given. Which party in the sale becomes the mortgagee? What, briefly, are the rights and remedies of each party?

A purchase money mortgage is one given to secure an unpaid portion of the purchase price of property. For an example

showing circumstances in which a purchase money mortgage normally would be given, see sec. 1047, subcaption, "Purchase money mortgages; junior and senior mortgages." The seller becomes the mortgagee, the buyer the mortgagor.

The rights and remedies of the parties are usually set forth in the mortgage itself. (See secs. 1146 and 1790.) In the absence of specification of rights and remedies in the mortgage, the mortgagee is entitled to have his principal and interest promptly paid; to have taxes, assessments and water charges promptly paid so that they will not become a lien on the premises; and to have the premises, as his security, maintained intact against damage, destruction, removal or deterioration. Upon the mortgagor's default, the mortgagee is entitled to foreclose the mortgage, to have the property sold to satisfy the debt, and in case of a deficiency at the foreclosure sale, to recover the deficiency from the mortgagor. The mortgagee in case of default need not foreclose his mortgage, but may sue on the bond or other written obligation evidencing the debt and secured by the mortgage.

The mortgagor is entitled to possession as owner of the premises so long as he does not default on the mortgage. This is sometimes referred to as his "equity of redemption," or "equity" (sec. 1157). In case of default he is entitled to preserve his *equity of redemption*, that is, to redeem his property from a forced sale under foreclosure by making good the default.

1787. NY Oct. 1938 (7). (a) Define or differentiate the following: real estate mortgage, chattel mortgage, purchase money mortgage.

(b) Name and distinguish the parties to a mortgage.

(a) See sec. 1780, subd. (c), and 1786.

(b) The parties to a mortgage are the *mortgagor*, who executes the mortgage to secure his obligation, and the *mortgagee*, to whom the mortgage is executed and delivered to secure the obligation due him.

1788. AI May 1942 (11). A real estate mortgage provides that the whole principal shall become due and payable upon any default in the payment of interest.

(a) Is the person who owes the money the mortgagor or the mortgagee? (Print your answer to assure legibility.)

(b) If the person who owes the money desires to avoid the expense of future interest payments, can he force the creditor to accept payment of the whole principal prior to maturity by an intentional default in an interest

payment? If your answer is in the negative¹, what legal reason can you give to support it?

(a) The person who owes the money is the mortgagor.

(b) The mortgagee, or person entitled to payment of the mortgage, cannot be compelled to accept such payment before it falls due according to the terms of the mortgage, unless there is a clause in the mortgage, known as a *prepayment clause*, which gives the mortgagor a right to prepay the mortgage. The "acceleration clause," which provides that the whole principal shall become due and payable upon any default in the payment of interest, is not absolute, but optional with the mortgagee. "A provision for acceleration is permissive only and not self-executing; it makes the whole debt due and collectable only in case the mortgagee so elects. . . . The right to declare the whole debt due for a preliminary default belongs to the mortgagee and not the mortgagor."¹

1789. NY Apr. 1941 (4). (a) State how a real estate mortgage should be executed by (1) an individual, (2) a corporation.

(b) State why a real estate mortgage should be recorded.

(a) (1) The formalities required for the execution of a mortgage differ in the different states. An indication of the usual requirements is suggested by the formalities for execution in New York, where a mortgage is executed in the same way as a deed, namely, (a) by signature of the grantor, (b) witnessing or acknowledging, and (c) delivery. In some states mortgages, though executed by an individual, must bear his seal as well as signature. In many states the requirement of a seal has been done away with. (See sec. 1050.)

(2) Execution of a mortgage by a corporation is similar to that governing a mortgage by an individual. The signature must be by a duly authorized officer on behalf of the corporation who, in acknowledging his signature (sec. 1050), usually recites that he was duly authorized by the board of directors to execute the instrument on behalf of the corporation. The corporate seal must be affixed to the mortgage. Usually, a corporate mortgage is not valid unless approved by a two-thirds vote of the stockholders (sec. 841), and a careful mortgagee requires a certificate by the secretary of the corporation that such stockholders' approval was duly given to the mortgage.

¹41 *Corpus Juris* 850.

(b) The real estate mortgage should be recorded so that all persons who thereafter acquire any interest or claim in the property will do so subject to the recorded mortgage. (See sec. 1148.)

1790. AI May 1935 (2). (a) In a transaction in which an owner of real property mortgages it upon obtaining a loan, describe all the rights which the mortgagee acquires.

(b) What remedies does the mortgagee have for the enforcement of his rights?

(c) Define and explain equity of redemption.

(a) The rights of the mortgagee in connection with a real estate mortgage are usually set forth in the bond and mortgage covering the transaction. The bond (in some states, a note or notes) evidences the debt and requires payment with interest on specified dates. Such obligation gives the mortgagee a right to sue on the debt regardless of the mortgage. The mortgage itself usually recites the following rights of the mortgagee: (1) to receive payment of the indebtedness; (2) to insure the property for the benefit of the mortgagee to the extent of his interest; (3) to have the building on the premises protected against damage, removal or demolition; (4) default clauses giving the mortgagee a right to declare the whole of the principal sum due upon default in the payment of any installment of principal when due, or of interest or taxes, water rates or assessments, after notice and demand following default; (5) to have a receiver appointed in case of foreclosure; (6) to require prompt payment of taxes, assessments and water rates; (7) to require the mortgagor within a fixed time limit to furnish a statement of the amount due on the mortgage; and (8) a warranty of title to the premises by the mortgagor. (See sec. 1146.)

(b) In addition to the remedy of suing on the debt itself (see subd. (a) above), the mortgagee may enforce his rights by foreclosing the mortgage. A suit in foreclosure, if successful, results in a judgment of foreclosure which shuts out all interests in connection with the mortgaged premises except those of the mortgagee. It entitles the mortgagee to a foreclosure sale out of the proceeds of which the mortgagee may collect the amount of the mortgage plus interest, costs, fees and expenses. If the property sells for less than such amount due, the mortgagee may enter a deficiency judgment and require

the mortgagor to make good the deficiency. (See sec. 1156.)

(c) What is now known as the mortgagor's equity of redemption in contrast to its former meaning (see sec. 1157), is the mortgagor's right within certain limits to redeem his property from a forced sale under foreclosure. The term is sometimes popularly used in abbreviated form (the owner's "equity") to denote the mortgagor's interest in the premises, exclusive of the amount of the mortgage.

1791. NY Apr. 1936 (8). *A* makes a bond and mortgage and afterward transfers the mortgaged property to *B*. As the mortgage approaches maturity, *B* applies to the holder of the mortgage for an extension of the time of payment. Will the granting of such an extension affect the liability of *A* on his bond and, if so, in what way?

The granting of the extension, *without A's consent*, will discharge *A* on his bond, to the extent of the value of the land. If the value of the land is less than the amount of the bond, or, to put it the other way, if the amount of *A's* bond exceeds the value of the land at the time of the extension, *A* will not be discharged as to such excess.

When the owner of land gives a bond and mortgage, and then conveys the property to another, subject to the mortgage, the grantee takes the land subject to the condition that it is to stand as security for the payment of the mortgage debt. At least to the extent of the value of the land, the grantee stands in the position of principal debtor on the mortgage debt (bond), and the grantor stands in the position of surety, including his right of subrogation in respect to the land, that is, his right, in case he pays the mortgage debt himself, to stand in the shoes of the mortgagee and to compel reimbursement from the grantee as principal debtor. If the mortgage debt exceeds the value of the land, the grantor remains solely liable as to such excess unless the grantee has assumed the mortgage debt himself, in which event he becomes primarily liable for the entire debt.

1792. AI May 1940 (11). A mortgagor of real property sold his equity of redemption to a purchaser who, for valuable consideration, signed an agreement whereby he promised the mortgagor that he (the purchaser) would pay to the mortgagee the amount of the mortgage debt. This agreement was not recorded and the mortgagee did not learn of it until the maturity date of the mortgage debt. Can the mortgagee enforce this agreement and compel the purchaser to pay the debt?

The mortgagee can enforce the agreement and compel the purchaser to pay the debt. When the grantee not only takes subject to the mortgage but assumes it, the mortgagee may hold either the grantee or the grantor for the full amount of the mortgage debt. He may hold the grantee under the Third Party Beneficiary Rules (sec. 200) because the promise was made to the grantor for the benefit of a third party (the mortgagee) and the grantee as promisee was obligated to such third party beneficiary. If the mortgagee prefers, however, he may hold the grantor, who is liable on the mortgage in the first place. If the grantor has to pay the debt, he in turn may hold the grantee, not only to the extent of the value of the property, but to the full extent of the debt, since the grantee assumed it. (See sec. 1791.)

The mortgagee's knowledge of the purchaser's obligation, or lack of it, is immaterial. The agreement did not involve the mortgagee's knowledge or assent, since it was not made with him, but for his benefit.

1793. AI Nov. 1940 (11). (a) What is a mortgage on personal property called? (Give the legal name for that kind of mortgage.)

(b) In what principal respect does such a mortgage differ from a pledge?

(a) A mortgage on personal property is called a chattel mortgage.

(b) A chattel mortgage differs from a pledge in the following respects: (1) as to the nature of the security; (2) as to the necessity of public notice, by filing; and (3) as to rights on default. (See sec. 472.)

CHAPTER XIV-A

Wills, Inheritance and Estate Administration

1794. NY Apr. 1937 (1). (a) Designate the individuals or authority whose action is necessary for the creation of a testamentary estate.

(b) Name the document or documents by which a testamentary estate is created.

(c) What are the provisions of the document or documents that must be known by an administrative accountant or independent auditor for use in connection with the accounts of a testamentary estate?

(a) The individual or authority whose action is necessary for the creation of a testamentary estate is the testator. The action necessary is the making of a last will and testament.

(b) The document by which a testamentary estate is created is a will.

(c) The provisions of a will that must be known by an administrative accountant or independent auditor for use in connection with the accounts of a testamentary estate are such as relate to the administration and disposition of the assets of the estate as distinguished from those parts of the will that have to do with its probative force. For example, an accountant in order to reflect on his books all the necessary items relating to the administration and disposition of the estate, and an auditor in order to audit such items, would be required to have exact knowledge of the specific legacies or bequests, the legatees to whom they are made, any distinctions set up between outright and conditional or contingent bequests, trust provisions and the terms thereof as a basis for computation of annuities, specific limitations, if any, in respect to executors' and trustees' fees, distinctions between bequests subject to tax and tax-free bequests, special suspense provisions pending the distribution of the estate, such as provisions for support of wife and children, and any other provisions bearing on the disposition of the testator's assets.

1795. AI and NY Nov. 1944 (7). (a) Can a paper or document not executed as a will be incorporated by reference in a properly executed will? Explain.

- (b) What is an attestation clause in a will and what is its importance?
- (c) What laws govern the distribution and succession of property of an intestate decedent who owned personal and real property in several states?
- (d) What are the duties of an executor?

(a) A paper or document not executed as a will may be incorporated by reference in a properly executed will only under the following circumstances:

(1) The document must be in existence at the time the will was executed.

(2) It must be referred to in the will as an existing document.

(3) It must be clearly identifiable and identified as the paper referred to in the will.

(4) The reference must show a clear intention by the testator to incorporate or adopt the document as part of the will.

(5) The document must be purely factual and must not in itself direct a disposition.

(For illustrations, see sec. 1170.)

(b) An attestation clause is a statement or certification following the will, signed by the witnesses, reciting that the will was signed, published and declared by the testator as and for his last will and testament, and that the witnesses thereupon, at the testator's request and in his presence and in the presence of one another, subscribed their names as attesting witnesses and their respective places of residence. The importance of an attestation clause is to fortify probate; that is, it strengthens prima facie evidence of the validity of a will. An attestation clause in most jurisdictions is not essential to the validity of a will.

(c) Where the intestate leaves real and personal property in several states, the real property passes in accordance with the law of the state in which it is situated (*lex situs*), and the personal property is distributed in accordance with the law of the decedent's domicile.

(d) The duties of an executor are to pay the debts of the estate and to distribute the assets as directed by the will. All other duties of the executor are subordinate and incidental to these major duties. The executor must file an inventory of the assets of the estate, take all steps necessary for the collection of such assets, and render a proper accounting to the probate court. (See secs. 1181, 1190-1207, and 1210.)

1796. AI May 1936 (10). What are the legal requirements in your state as to witnesses and other formalities for the proper execution of a last will and testament? (Name the state to which your answer relates.)

The legal requirements as to witnesses and other formalities for the proper execution of a last will and testament vary in the different states. The most common provision is that the will must be in writing, subscribed by the testator at the end thereof in the presence of at least two attesting witnesses,¹ or else acknowledged by the testator before such witnesses to have been signed by him, accompanied by a declaration by the testator to the witnesses that the instrument is his last will and testament. The foregoing requirements are those prescribed by the New York statute. The requirements in most other states are substantially similar.

1797. NY Oct. 1940 (11). (a) In the distribution of intestate property of the deceased, the following terms were used: (1) Collaterals, (2) ascendants, (3) descendants. Describe briefly each of these terms and state its relation to distribution.

(b) What are cy-pres powers?

(a) (1) Collaterals include brothers and sisters, or their children (nephews and nieces), or brothers and sisters of parents (i.e., uncles and aunts), or their children (i.e., cousins).

(2) Ascendants include parents, grandparents, great-grandparents, and so on.

(3) Descendants include children, grandchildren, great-grandchildren, and so on.

(b) See sec. 1241.

1798. NY Oct. 1938 (4). (a) Distinguish between *executor* and *administrator*, and state whence they derive authority.

(b) What is the ordinary procedure when a person of property dies without leaving a will and it is the desire of the heirs to have the estate duly settled?

(a) An *executor* is a person named in a will to execute or carry out its terms. An *administrator* is a person named by the Court to administer and distribute the estate of a person who dies intestate. The authority of an executor is derived from the testator himself; of an administrator, from the Court.

(b) A petition is made in the probate or surrogate's court for the issuance of letters of administration to a person duly qualified (that is, for the appointment of an administrator). Letters of administration will be granted only to competent

¹Some states—for example, Maine, Connecticut, and Massachusetts—require three witnesses. Other states—for example, Pennsylvania—require none.

persons entitled to share in the decedent's personal property and willing to accept the administration. Any person interested in the estate may apply for the letters, but certain persons have a prior right over others. Notice of the application for letters must be given to all persons having a prior or equal right to apply for them. Upon the surrogate's decree granting the letters, the administrator qualifies by filing a bond and is ready to undertake the duties of administration.

1799. AI Nov. 1942 (2). The following questions relate to the administration of the estate of a decedent:

(a) Define *executor*, *administrator*, and *testamentary trustee*.

(b) What in general are the duties of an executor, an administrator, and a testamentary trustee?

(c) What is meant by an executor's account and what is the purpose of it?

(d) If an executor retains a certified public accountant to perform accounting services, who is primarily responsible for the payment of the accountant's fee?

(a) For definitions of an *executor* and an *administrator*, see sec. 1798, subd. (a).

A testamentary trustee is a trustee named in a last will and testament.

(b) For the duties of an executor, see sec. 1795, subd. (d).

The duties of an administrator are similar to those of an executor except that an administrator, in the management and distribution of the assets of an estate, is governed by the rules of law controlling intestate succession instead of by the directions of the decedent, which are controlling upon the executor, and except, further, that an administrator must always furnish a bond, whereas an executor need not do so if the will dispenses with such requirement.

The basic function of a testamentary trustee is to assume custody, invest and manage the property entrusted to him, to distribute the income thereof to the beneficiaries named in the trust, to make ultimate distribution of the corpus in accordance with the terms of the trust, and to render periodic accounting during the course of the administration of the trust and a final accounting to the Court upon termination of his duties.

(c) An executor's account is the report that he is required to make upon his accounting to the Court, setting forth in narrative form, supplemented by schedules, the story of his

stewardship. The account shows the original assets received by the executor, the assets subsequently discovered and collected, the proceeds from the sale of property, increase in capital assets, gross income from any source, charges against assets (such as administration expenses), loss or shrinkage in value from any cause, legacies distributed, and so on. (See sec. 1200.) The purpose of an intermediate account is usually informatory; the purpose of a final account is to secure a judicial settlement. (See sec. 1260.)

(d) If an executor retains a certified public accountant to perform accounting services, he is primarily responsible for the payment of the accountant's fee. Unless the fee is subsequently approved by the Court, he may be surcharged for it, that is, required to account for it to the estate out of his own funds.

1800. AI Nov. 1937 (11). George Griffin was an accommodation endorser on a negotiable promissory note, and he died prior to the maturity of the note. On the day when this note became due, Griffin's executor, at the payee's insistence and without receiving consideration therefor, endorsed a renewal note as follows: "Estate of George Griffin, deceased, by Edward Patterson, Executor."

(a) Did this endorsement discharge the estate from liability upon the original note?

(b) Did the executor become personally liable by this endorsement?

(a) "The indorsement did not discharge the estate from liability upon the original note unless it was necessary and beneficial to the estate. An executor has no right to indorse a renewal note on behalf of the estate unless in so doing he creates no new obligation but merely recognizes the enforceability of an existing one. If, in the situation presented, the new note was given for the purpose of obtaining an extension of time on the old one or some other benefit to the estate and if there was no valid defense to the original note, so that the renewal note created no new obligation, the indorsement discharged the estate from liability upon the original note; otherwise not.

(b) The executor did not become personally liable by his indorsement. If his indorsement was authorized in line with (a) above, the liability would be that of the estate and not of the executor. If his indorsement was unauthorized, the executor's representation of authority contained in his signature would be a representation of the law (opinion) and not of fact, on which no liability could be based.

1801. NY Oct. 1939 (10). In the preparation of an inventory of the estate of a decedent, to what extent should the following be included: (a) Real estate, (b) stocks and bonds, (c) dividends on cumulative preferred stock, (d) interest on coupon bonds?

(a) Real estate should be included to the extent of the decedent's equity in the property, that is, the net value of his interest after deducting the amount of the mortgage debt. In practice, it is customary for the schedules to set forth (1) the gross value (as determined by appraisal or on the basis of assessed valuation), (2) mortgage debts outstanding against the property and (3) the difference, or value of decedent's equity, upon which the estate transfer tax is based.

(b) Stocks and bonds owned by the deceased are includible in the inventory at the fair market value on the date of death. If the deceased maintained a margin account with a stockbroker, the securities so carried should be inventoried at their fair market value, less the amount due the stockbroker; i.e., only the equity of the estate in the securities should be set up.

(c) The rule applicable to cash dividends declared but not paid during the lifetime of a decedent is not uniform, some states holding that the effective date is the date of declaration, others that the record date controls. The present tendency is toward the latter rule, which may be regarded as the majority rule. (See sec. 1264, "Effective dividend date.") The fact that the stock is cumulative preferred does not change the rule. To designate stock as "preferred" is to establish, not a *fixed* claim, but a *prior* or *preferred* claim over stock not having a preference. Dividends must be declared by the board of directors before they become payable, and they are payable only out of earnings.

(d) Interest on coupon bonds accrued from the last interest payment down to and including the date of death should be included in the inventory.

1802. NY Apr. 1943 (6). As to each class of assets in the estate or mentioned in the will of a testator, indicate as "correct" or "wrong" the action of the executor in including in his inventory the items below stated at values as of date of death. Give your correction and reasons for those, if any, you show as "wrong."

- (a) Preferred stock at market value plus accrued dividend.
- (b) Real estate at value as per tax assessment.
- (c) Coupon bonds at market value plus accrued interest.
- (d) Common stock at market value plus declared unpaid dividends.
- (e) Note receivable overdue at face plus accrued interest.

(a) Wrong. See sec. 1801, subd. (c).

(b) Wrong. See sec. 1801, subd. (a).

(c) Right. The accrued interest on bonds, unlike dividends on preferred stock, represents an actual obligation, regardless of the date when it is payable. The bonds plus accrued interest belonged to the testator at the time of his death and should be included in the inventory.

(d) Wrong. See sec. 1801, subs. (b) and (c).

(e) Right. When a note becomes due, interest at the legal rate is accruable thereon by operation of law.

1803. NY Oct. 1943 (11). The estate of a decedent consists of realty and personalty. The administrator collects the personalty to the amount of \$15,000 and collects rents of \$2000 from tenants of the realty. The debts of the decedent and estate amount in all to \$16,000. Discuss the action you would expect counsel to advise.

Ordinarily, all property in the estate is subject to debts, but personal property must be applied first and then the realty. In states that follow the common law rule, an administrator has no authority in respect to a decedent's real property, such property passing directly to the heirs. In some states, as in New York (this being a New York question), an administrator is given specific statutory authority to take possession of real property, manage it, and collect rents, thereby giving creditors protection that did not exist at common law. The right of an administrator to collect rents from real property of the estate and apply them to payment of the debts is deemed an additional asset of the estate.² Counsel would therefore advise the administrator that he may apply out of the \$2000 collected in rents the sum of \$1000 in payment of the deficiency due on account of the debts of the decedent.

1804. NY Apr. 1942 (3). A manufacturing company filed with the executor of a decedent's estate its claim for the amount of two time-notes received from the decedent upon its sale of merchandise to him.

(a) List in the required order the debts, if any, that the executor must pay before payment of the notes to the manufacturing company.

(b) What difference, if any, would it make if one note had matured before the decedent's death? Explain.

(a) The debts that the executor must pay before payment of the notes to the manufacturing company are, after payment of administration expenses and funeral expenses: (1) Debts

² *In re Baker's Estate*, 164 Misc. 92, 298 N.Y. Supp. 261.

entitled to preference under United States and state laws,³ (2) local taxes assessed on property of the decedent before his death, and (3) judgments according to priority of docketing (filing).

(b) It would make no difference if one note had matured before the decedent's death. Among creditors of the same class there is no preference: they share pro rata. The only priority is in the due date of the obligation. If the matured note were sued on, however, and the claim reduced to judgment, such claim would fall into class (3) in subdivision (a) above. It would then be entitled to priority over the unmatured note.

1805. NY App. 1936 (9). What is a lapsed legacy? How should it be disposed of by an executor? When does a general legacy begin to bear interest?

A lapsed legacy is one payable to a legatee who dies before the testator or before the legacy is payable. Under the common law, such a legacy would fall into the residuary estate. Today, this rule does not apply to a devisee or legatee who is either a child, grandchild, brother or sister of the testator, provided such devisee or legatee, upon predeceasing the testator, leaves a child or other descendant surviving, in which event, the child or other descendant would take. Thus, if a testator leaves one legacy to his brother, another to his friend, and the rest, or residuary estate, to his grandchildren, and if the brother and the friend predecease the testator, each leaving a son, the friend's legacy would lapse and fall into the residuary estate, but the brother's would go to his son (the testator's nephew).

The executor should dispose of a lapsed legacy by paying it to the residuary legatee or legatees.

A general legacy begins to bear interest when it is payable, not before. For example, in *Matter of Hier*,⁴ a legacy of \$10,000 was payable to a grandchild upon his reaching the age of 21 years. The Court, in reversing the decree below and refusing interest to the grandchild until he reached his majority, held: "We think this case falls within the general rule that interest on legacies may not be allowed until after they become payable under the terms of the will."

³ These include, first, Federal and state taxes, then other debts accorded priority under Federal and state laws.

⁴ 205 App. Div. 215, 199 N.Y. Supp. 623.

CHAPTER XV-A

Trusts

1806. NY Apr. 1939 (1). (a) What is a trust?

(b) A trustee uses the principal of a trust fund for the purchase of real estate which needs minor repairs to secure a tenant. Are such repairs chargeable to principal or to income?

(c) Explain.

(a) A trust is a confidence reposed in one person with respect to property held by him for the benefit of another.

(b) The repairs are chargeable to principal.

(c) Repairs needed to put premises in a tenantable condition have been held to be of a permanent nature, hence chargeable to principal. "The special guardian objects to the trustee charging to capital the expense of certain repairs made to premises which are part of the trust estate. This property was acquired under foreclosure proceedings, and the repairs were necessary to put the property in tenantable condition.

They were of a permanent nature, and are properly chargeable to principal, and the objection of the special guardian is overruled."¹ "Although the question as to whether the expense of repairs and improvements shall be paid out of capital or income may be left to the discretion of the trustee, as a general rule, the expense of ordinary repairs or improvements not of a permanent character, of trust property is chargeable against the income of the property. . . ."²

1807. NY Apr. 1940 (13). (a) Compare the relationship of a debtor and creditor with that of a trustee and beneficiary.

(b) A gives B a sum of money to invest for the benefit of C. The investment results in a loss. To what extent is B liable?

(c) A trustee becomes insolvent. Compare the respective rights of the beneficiary and of general creditors.

(d) Compare the limitations upon an action by a creditor against a debtor with that upon an action by a beneficiary against a trustee.

¹In *Re Suydam's Estate*, 138 Misc. 873, 248 N.Y. Supp. 176, 179.

²65 *Corpus Juris* 714.

(a) The relationship of a debtor and creditor differs from that of a trustee and beneficiary in four respects: (1) as to the nature of the obligation, (2) as to liability for loss, (3) as to rights of creditors in case of insolvency, and (4) as to the time when the statute of limitations begins to run on the obligation. (See sec. 1217.)

(b) *B* is liable only in case he failed to exercise reasonable judgment in connection with the investment.

(c) The beneficiary is in a preferred position. He has a prior right to so much of the trustee's assets as represent trust property or its proceeds. The general creditors are entitled only to a *pro rata* share of the trustee's personal assets.

(d) The statute of limitations begins to run in favor of a debtor when the obligation matures (sec. 98); but it does not begin to run in favor of a trustee until he openly repudiates the trust. Moreover, the period of the statute of limitations is usually longer in equity actions, which include actions upon a trust.

1808. NY Oct. 1935 (12). What are *four* essential elements of a valid legal trust of personal property?

Four essential elements of a valid legal trust of personal property are:

(1) *Subject matter*, or trust *res*, which must be sufficiently identified or identifiable so that it can be appropriated to the trust, and which must represent a legitimate property interest not contrary to law or public policy.

(2) *Parties*, including the donor (also known as *trustor*, *settlor*, *creator* and *funder*), who creates the trust; the trustee, in whom is vested the legal title to the property subjected to the trust; and the "cestui que trust," or beneficiary, for whose benefit the trust is created. A donor and beneficiary are absolutely essential to the trust; but equity will not permit a trust in other respects valid to fail for want of a trustee, and will in such case appoint a trustee.

(3) *Consideration*, where the trust is executory (sec. 1221).

(4) *Certainty*. It is an essential requirement of every express trust that the intent of the settlor to create a trust shall be clearly expressed, so that there can be no question as to whether in fact a trust was intended. Not only must the settlor's intention to create a trust be clear from the language used, but the declaration of trust must be sufficiently explicit

so as to designate with reasonable certainty the subject matter, purpose and beneficiary of the trust. Otherwise, the trust is impossible of execution. (For examples, see sec. 1223, subd. 4.)

1809. AI-NY May 1945 (7). (a) What are *four* essential elements in the creation of a valid express trust of personal property?

(b) For a trust having real and personal property in several states, what law governs the validity of the purpose of

(1) A trust of real property?

(2) A testamentary trust of personal property?

(c) What disbursements should a trustee make (1) from income, (2) from principal, (3) to beneficiaries? Are there any exceptions as to (1), (2) or (3)?

(d) The trustee of an estate deposits \$10,000 of the trust funds, together with \$10,000 of his own money, in his personal bank checking account. The bank fails. No fraud is charged against the trustee. Nothing is realized from the bank on liquidation. Who sustains the loss? Is the trustee liable to the estate?

(a) See sec. 1808.

(b) (1) The validity of the purpose of a trust of real property is governed by the law of its location (*lex situs*).

(2) The validity of a testamentary trust of personal property is governed by the law of the donor's domicile.

(c) (1) The ordinary expense of administering and preserving a trust is generally chargeable to income.

(2) Unusual and extraordinary expenses which go toward enhancement or preservation of the principal are chargeable to principal, not income.

(3) The disbursement or distribution to be made to beneficiaries is governed by the terms of the trust. The income or yield of the trust goes to the persons designated as life beneficiaries, or beneficiaries for a given period; the corpus or principal of the trust goes to the person or persons designated as remaindermen. Generally speaking, income includes any earnings derived from the use and management of trust property, or from a business held in trust. The principal or corpus of a trust includes property originally coming into the trustee's hands, plus its increase in value, or any new form of investment which such property may take, or any proceeds from the sale of such property, including profits realized on such sale.

There are a number of exceptions to the foregoing rules: (i) Interest on bonds which is payable during the life of the trust,

but which accrued prior to the decedent's death, constitutes principal and is payable as such; (ii) where bonds are purchased by the trustee at a premium, the trustee must make sufficient deduction from interest on such bonds to amortize the premium (see sec. 1267); (iii) the testator may provide for exceptions to the rules of apportionment between principal and income, as in the case of a provision for invasion of principal (sec. 1274). (For further details as to apportionment between principal and income, see secs. 1262-1273.)

(d) The trustee sustains the loss. He is liable to the estate. A fiduciary who commingles estate funds with his own is not only guilty of a misdemeanor, but is liable to the estate for any loss or shrinkage while the funds are so commingled. This would be true regardless of the trustee's good faith (secs. 1202 and 1254).

1810. AI May 1943 (8). (a) What are the two principal types or kinds of irrevocable trust classified according to the method of creating the trust?

(b) If one person is duly appointed executor of a will and also trustee of a trust created by that will, when can he begin to act as trustee and should he keep separate books of account for the trust in addition to books of account for his transactions as executor?

(c) Name some of the legal restrictions which limit the purposes for which valid trusts can be created.

(d) Give an example of an intangible wasting asset, and indicate how the trustee should account for cash receipts produced by such an asset.

(a) Express trusts may be created either by (1) a disposition *inter vivos*, or living trust, namely, one which becomes effective during the donor's lifetime, and (2) by a testamentary provision, which becomes effective after the donor's death. In the case of a living trust, the donor's disposition may be revocable or irrevocable, depending on the terms of the trust. A testamentary trust becomes irrevocable upon the donor's death, though its benefits may shift upon contingencies named in the trust (sec. 1222, "Shifting trusts").

A person may subject property to a trust in one of two ways: (1) He may transfer the property subject to a trust; and (2) he may constitute himself trustee, without any transfer, by a declaration of trust. In the former case, when the transfer is complete, and the trust executed, it becomes irrevocable, as where the donor conveys real property by deed to a trustee subject to a trust instrument, and delivers the deed. In the second situation, when a person constitutes himself a trustee

by a declaration of trust, the declaration, accompanied by an act showing finality, renders the trust irrevocable, as in the case of a savings bank trust (sec. 1236) where the settlor physically transfers the passbook to the beneficiary, or dies without having revoked the trust.

(b) A person named as executor and also trustee under a will can begin to act as trustee only when the trust property or fund has been set up. This usually cannot be done until the administration of the estate by the executor as such has been completed, including probate, collection and conversion of estate assets, payment of debts, taxes and administration expenses, and distribution in accordance with the will, including the setting up of the trust fund. The distribution is made pursuant to the executor's final accounting, which must be approved. If the testator creates a trust, but names no trustee, or the trustee dies, renounces or is disqualified, the executor must set up a trust fund, retain it in his custody, and attend to such administrative duties in respect to it as may be necessary pending court appointment of a trustee.

Separate books of account should be kept for the trust in addition to books of account for the fiduciary's transactions as executor.

(c) Some of the legal restrictions which limit the purposes for which valid trusts can be created are: (1) some states, notably Michigan, New York and Wisconsin, have abolished all uses and trusts in lands except such as are expressly authorized by statute (see sec. 1227); (2) the rule against perpetuities prevents tying up title to property in such a way that for an unreasonable period of time, no one can be pointed to as the person who has the absolute right to transfer title and possession to the property; and (3) the rule against accumulations in connection with personal property declares that accumulations of interest upon principal are void unless they are limited to the period of infancy. (See secs. 1228-1230.)

(d) Examples of intangible wasting assets are leaseholds, patent rights, copyrights, licenses and any contracts, generally, which create rights for a limited period. Income on such assets, in the form of rents, royalties, and so on eats away principal to the extent that it shortens the income-producing life of the estate. To make up for this erosion of principal, the trustee is required to retain a portion of the cash receipts pro-

duced by such an estate, sufficient to replace the asset, or its value, upon its becoming completely exhausted.

1811. NY Apr. 1944 (12). (a) Name two classes of trusts based upon the purpose of each.

(b) Name two classes of trusts based upon how they were created.

(c) Name the classes an accountant is most likely to meet in his work, giving your reason.

(a) Eight classes of trusts based upon the purpose of each are: (1) trusts for married women, (2) family settlement trusts, (3) spendthrift trusts, (4) charitable trusts, (5) insurance trusts, (6) investment trusts, (7) voting trusts, and (8) trusts for the benefit of creditors. (See secs. 1237-1244.)

(b) Two classes of trusts based on the manner in which they were created, are: (1) trusts *inter vivos*, or living trusts, namely, those which become effective during the donor's lifetime, and (2) testamentary trusts, which become effective after the donor's death. Another classification which may be made in respect to the manner of creating a trust, or, speaking more exactly, the manner in which property may be subjected to a trust, are: (1) by the donor's transfer of property subject to a trust, as in the case of the transfer of real property by a deed subject to a trust, and (2) by the donor's constituting himself trustee, as by a declaration of trust in respect to property in his possession. (See sec. 1231.)

(c) Accountants (except those who specialize in the investment field) are most likely to meet with family settlement trusts and trusts for the benefit of creditors. The former are usually set up by will, the administration of which frequently demands the services of an accountant, especially for inventory and estate tax requirements (secs. 1192 and 1210), together with problems of apportionment between principal and income (secs. 1262-1273). Another class of trusts which an accountant is likely to meet in his work are those created for the benefit of creditors, particularly those relating to assignments for the benefit of creditors and the duties of a trustee in bankruptcy proceedings (secs. 1244 and 1307).

1812. AI Nov. 1937 (12). The garnishee laws of a state entitle a judgment creditor to 10% of the income of his judgment debtor and under those laws a garnishee execution, duly issued on a \$50,000 judgment, ordered a life insurance company to deduct and pay to the creditor 10% of the income from a trust fund held by it. This trust fund consisted of the proceeds of a life insurance policy, \$40,000, which the policy provided should be held

by the company at 3% interest and paid to the judgment debtor as beneficiary in equal monthly installments of \$500 as long as said proceeds with interest thereon should last.

(a) Is the judgment creditor entitled to 10% of the total of each installment?

(b) If not, how would you determine the amount to which he is entitled, and would that amount remain constant, increase, or decrease up to and including the last \$500 installment?

(a) The judgment creditor is not entitled to 10% of the total of each installment.

(b) The installments obviously include principal as well as interest. Interest on \$40,000 at 3% amounts to \$1200 per annum, or \$100 per month. Thus, \$400 out of the first monthly installment represents principal. The garnishee laws referred to entitle the judgment creditor to 10% of the judgment debtor's income only. The amount of income subject to garnishment will become less with each monthly installment payment, to the extent that such installment payment includes principal and leaves less principal on which interest is payable. Hence the amount to which the judgment creditor is entitled on his garnishee execution would have to be determined by a mathematical formula which would take into account the diminishing monthly income installments proportioned to the diminishing principal on which such income is based.

1813. NY Oct. 1940 (11). (a) In the distribution on intestate property of the deceased, the following terms were used: (1) collaterals, (2) ascendants, (3) descendants. Describe briefly each of these terms and state its relation to distribution.

(b) What are *cy-pres* powers?

(a) See sec. 1797.

(b) Where the purpose of a charitable trust becomes impossible of fulfillment in accordance with the donor's intentions, the Court may, in exceptional cases, adapt the charity as nearly as possible to the donor's original intention. Powers so bestowed upon the trustee by the Court are known as *cy-pres* powers. (For an example, see sec. 1241.)

1814. NY Apr. 1937 (8). (a) What is meant by the term *escrow*?

(b) State the parties to a transaction involving escrow.

(c) Compare an escrow agreement with agency.

(a) The term *escrow* denotes a conditional delivery to a third party for custody pending the happening of some event. For example, the delivery of a deed in escrow is its delivery to

a third party, to be held by the latter until the happening of a contingency or the performance of a condition, and then to be delivered to the grantee. The term *escrow* is sometimes applied to the written instrument itself, which is deposited with the third party for ultimate delivery upon specified conditions.

(b) The parties to a transaction involving escrow, particularly as related to a deed or similar instrument, are grantor, grantee and escrow holder. As related to instruments generally, the parties are sometimes referred to as donor, donee and depository.

(c) An escrow agreement differs from an agency in that the escrow holder's authority is usually irrevocable by either party, whereas a principal always has the power (though not always the right) to revoke an ordinary agency not coupled with an interest. Another difference is that an agent cannot represent two or more principals with adverse interests. This is not true of an escrow holder. (See sec. 1557, subd. (c).)

1815. NY Apr. 1936 (12). What is meant by placing a document, or fund, in escrow?

What is the effect of such an act?

By placing a document or fund in escrow is meant the conditional delivery of such document or fund to a third party for custody pending the happening of some event. (See sec. 1814, subd. (a).)

To place a document or fund "in escrow" is to intrust such document or transfer such fund to a person charged with its custody and disposition in accordance with the terms of a specific agreement, known as the *escrow agreement*. The effect of such a transaction is to impose upon the escrow holder an obligation in the nature of a trust, so that a breach of such obligation will amount to a breach of such trust. For example, a grantor of property may deliver the deed in escrow to the X Trust Co., pursuant to an agreement between the grantor and the grantee requiring the latter to pay the purchase price to the trust company, upon payment of which the trust company is instructed to deliver the deed. The effect of such an arrangement is to charge the trust company with the responsibility of a trustee as to the deed, and with liability for breach if the deed be delivered to the grantee without performance by the latter of the terms of his agreement.

1816. AI and NY Nov. 1944 (12). (a) Arms is trustee of the Jones estate. He appoints Bush his agent to perform his trust duties. Bush fraudulently misappropriates \$1000 of the trust funds. Arms, the trustee, is sued for the amount.

(1) Can Arms, the trustee, delegate his trust duties to Bush, his agent? Explain.

(2) Is Arms liable? Why?

(b) What is an auctioneer?

(c) Whom does an auctioneer represent?

(d) Name some of the implied powers of an auctioneer.

(e) Name *three* limitations to the powers of an auctioneer.

(a) (1) Arms cannot delegate his trust duties to Bush. A trustee is selected for his judgment, discretion and integrity. Duties calling for the exercise of these qualities cannot be delegated, in the absence of specific authority to delegate them (sec. 1253). See sec. 1588, subd. (a).

(2) Arms is liable. A trustee who delegates a strictly trust function which he should attend to personally, is liable for consequent loss, since the loss resulted from a breach of duty.

(b) See sec. 1588, subd. (b).

(c) See sec. 1588, subd. (c).

(d) See sec. 1588, subd. (d).

(e) See sec. 1588, subd. (e).

1817. NY Apr. 1941 (15). Is the legal liability of a trustee in the case of a loss any greater where the trust funds are not kept separate than where they are kept in a separate deposit, it being admitted that the trustee acted in good faith? Explain.

Where trust funds are commingled by the trustee, his legal liability for loss is absolute, regardless of the question of good faith. (See sec. 1809, subd. (d).)

1818. AI Nov. 1935 (8). In the absence of any applicable statute, what is a testamentary trustee's duty as to (a) amortization of premiums on bonds purchased by him, (b) amortization of premiums on bonds purchased by the testator and acquired by the trustee as a part of the trust fund, (c) accumulation of discounts on bonds purchased by the trustee?

(a) In the absence of any applicable statute, a testamentary trustee's duty as to bonds purchased by him at a premium is to amortize the premium by making deductions from interest payments, so that when the bonds are redeemed at par the trustee will have an additional sum set aside which, with the face amount of the bonds, will equal the original outlay of principal.

(b) When the bonds were purchased by the testator at a premium and acquired by the trustee as part of the trust fund, the trustee is not required to amortize the premium, and the interest on the bonds, without deduction (except for the amount accrued prior to the testator's death), goes to the life beneficiary.

(c) In the majority of jurisdictions, the logic of the rule that on bond redemption at maturity the amount in the trustee's hands should equal the valuation at death (in case of purchase by the testator) or the outlay of principal (in case of purchase by the trustee), is not applied in the case of bonds purchased at discount. The life beneficiary in such cases receives only the interest on the bonds, and upon maturity, the accumulated discount falls into principal.

It should be noted that the foregoing rules are modified by statute in the states which have adopted the Uniform Principal and Income Act. By the provisions of that act (sec. 1267) bonds in a testamentary trust are deemed principal at their inventory value, or in default thereof at their market value, at the time the principal was established, or at their cost when purchased later, regardless of their par or maturity value; and upon their respective maturities, or upon their sale, any loss or gain realized thereon is chargeable or credited to principal.

1819. NY Oct. 1941 (9). A decedent left income-producing assets of \$500,000 and by his will provided for general legacies of \$300,000, with the remainder of the estate in trust, the income to be paid to the widow during her life and thereafter the fund to be delivered to their son. Debts, taxes and administrative expenses amounted to \$100,000 and were paid within one year from the testator's death, during which year the income received was \$25,000. Should all or parts of this realized income be paid to the general legatees, to the widow or to the trustee?

(A textual answer correctly stated will be accepted, but you may answer with computations if you wish.)

This problem raises the question of apportioning income earned during the period of administration. This being a New York question, the New York statute will be used as a guide.

The will provides for general legacies of \$300,000, with a residuary estate in trust to the widow for life and remainder to the son. Interest on general legacies is not payable until after the close of the administration period for payment of debts

and legacies.³ Under the New York statute,⁴ unless otherwise provided by will, all income earned during the administration period not otherwise payable or disposed of by will "shall be distributed pro rata as income among the beneficiaries of any trusts created out of the residuary estate of such testator and the other persons entitled to such residuary estate. None of such income shall, after such distribution, be added to the capital of such residuary estate, the whole or any part of which is devised or bequeathed in trust or for life or for a term of years, but shall be paid ratably to the life beneficiary of a trust, or to the life tenant, or to the absolute residuary legatee, as the case may be. Unless otherwise directed in the will, income shall be payable to the life beneficiaries of trusts, or to life tenants, from the date of testator's death."

In this case, there is a beneficiary of a trust created out of a residuary estate, the widow, but no life tenant or absolute residuary legatee (the son being entitled only to the remainder in trust). Hence the widow will take all income earned since the testator's death, including income earned on general legacies during the administration period.⁵ In other words; the widow, under the New York statute, would be entitled to the entire income of \$25,000.

1820. NY Oct. 1941 (15). In a trust created by the will of a testator, where the income was to be paid to a beneficiary for 10 years and the principal was then to be paid to a legatee, the principal of the trust included two securities: viz., one upon which a dividend was declared before the testator died and one upon which a stock dividend was declared during the life of the trust.

- (a) Was the first-described dividend income or principal?
- (b) Was the second-described dividend income or principal?
- (c) May a person who is named in a will as executor and as trustee collect commissions in both capacities?
- (d) Discuss your answer to (c).

(a) Presumably the first-described dividend was a cash dividend, since the second is specifically referred to as a "stock" dividend. The law governing apportionment of cash divi-

³ The administration period indicated in the problem is one year. This is the prevailing statutory period. In New York, however, this period has been shortened to seven months, and may be shortened even further. (See sec. 1204.)

⁴ Sec. 17-b, Personal Property Law.

⁵ *Matter of Dunn*, 170 Misc. 702, 10 N.Y.S. 2d, 766.

dends declared during a testator's lifetime is not uniform. In some states the date of declaration governs. In other states the record date of ownership governs. This being a New York question, the pertinent New York statute⁶ will be applied. If the testator were a stockholder of record on the date as of which the dividend was payable, such dividend would become part of the testator's estate at the time of his death, namely, it would constitute principal. If the dividend was payable to stockholders of record at a date subsequent to the date of the testator's death, it would be payable as income since income earned during the administration period not otherwise payable or disposed of by will must be distributed as income among the beneficiaries of any trusts created out of the testator's residuary estate. (See sec. 1819.)

(b) The second-described dividend, being a stock dividend, constitutes principal (sec. 1264, "Stock dividends").

(c) When the same person is designated in a will both as executor and as trustee, he cannot charge double commissions unless his functions as executor are separate and distinct from those as trustee.

(d) See sec. 1261.

1821. AI-NY Nov. 1945 (6). (a) In the absence of directions in the trust instrument, what are the duties of a trustee as to:

- (1) Income received from bonds purchased at a premium?
- (2) Income from a wasting asset, such as royalties from a patent?

(b) What are the responsibilities of a trustee as to payments chargeable to (1) principal, and to (2) income?

(c) Which of the following charges are chargeable to principal and which are chargeable to income of a trust?

- (1) Cost of litigation to construe the meaning of trust provisions.
- (2) Cost of creating or continuing the trust.
- (3) Premium on trustee's bond.
- (4) Cost of finding trust assets.
- (5) Insurance.
- (6) Interest on mortgage.

(a) (1) See sec. 1818, subd. (a).

(2) See sec. 1810, subd. (d).

(b) See sec. 1809, subd. (c).

(c) (1) Legal expenses in construing a trust provision, if incurred on authority of the trustee and on behalf of the estate, are chargeable to the estate; if incurred on behalf of a

⁶ Personal Property Law, sec. 17-e, added by amendment in 1946 (see sec. 1264, "Effective dividend date").

life beneficiary in opposition to the trustee, or in a contest with a remainderman, they are chargeable to such life beneficiary, unless the probate court otherwise directs.

(2) The cost of creating or continuing the trust is chargeable to principal. (See sec. 1273, "Cost of creating or continuing trust.")

(3) The initial premium on the trustee's bond is chargeable to principal, but recurrent annual premiums on a continuing trust, being in the nature of management expense, are chargeable to income.

(4) The cost of finding trust assets is part of the cost of creating or continuing the trust, and is chargeable as principal.

(5) The cost of insurance, being part of the carrying charges of a trust estate, is chargeable to income.

(6) Interest on a mortgage covering premises which are part of the trust estate, being part of the carrying charges, is chargeable to income.

1822. NY Apr. 1943 (10). What are two places in the transactions stated below in which the trustee's bookkeeper may fall into errors in determining the amounts payable to the beneficiary if he is not familiar with fiduciary law and accounting?

Three months after the last prior coupon date a trustee received from a donor of a trust \$20,000 par of 5% bonds which then were quoted at 90.

Nine months later the bonds were called at 105, and the trustee invested the proceeds in other 5% bonds on their coupon dates at 94½ exmatured coupons.

Six months later the trust expired by limitation, and the trustee delivered the principal to the remainderman.

(NOTE: This is a question in commercial law, but if you prefer to treat it as a problem, a correct solution will be given full credit.)

The bookkeeper may fall into the following errors unless carefully guided by the law applicable in the particular jurisdiction governing the testamentary trust in question:

(a) At the time of setting up the trust the bookkeeper might enter the bonds at their par value. This would be contrary to the statutory provision applicable in jurisdictions which have adopted the Uniform Principal and Income Act (sec. 1267), where premium and discount bonds are required to be entered as principal at their inventory value or, in default thereof, at their market value at the time the trust was established.

(b) When interest is first collected, the bookkeeper may overlook the fact that at the time the trust was set up, three

months' interest had accrued on the bonds, and that such interest would have to be allocated to principal, since it belonged to the donor when the trust was created.

(c) A New York bookkeeper, or a bookkeeper in any other state which has adopted the Uniform Principal and Income Act provision relating to premium and discount bonds (sec. 1267), might assume that since the statute in such jurisdiction has abolished the requirement of premium amortization, the benefit of the discount accumulation on bonds purchased below par should go to income instead of principal, on the theory that such bonds are deemed principal at their inventory value or, in default thereof, at their market value at the time the trust was established, and therefore, since the bonds were quoted at 90 at the time the trustee received them from the donor, the principal was to be credited only with 90% of the proceeds of the bond redemption at par. This would be erroneous, because it would overlook the specific provision of the statute that any gain realized upon the maturity of such a bond enures to principal.

1823. AI May 1939 (9). A testamentary trustee received from the executor of testator's will shares of stock in a corporation and subsequently he purchased additional shares of the same stock. Thereafter the corporation issued and the trustee received rights to subscribe to new stock of the same character. What principles and rules of law should the trustee have in mind when he decides what to do about these rights?

The trustee should have in mind that under the prevailing rule governing stock subscription rights, all such rights and the proceeds from the sale thereof must be deemed principal. (See sec. 1265.) If the trust is subject to a jurisdiction which recognizes the minority or Pennsylvania Rule (sec. 1265), the trustee should apportion "intact value" to principal and the rest to income. (For an illustration of the Pennsylvania Rule relating to "intact value," see sec. 1265.)

1824. AI Nov. 1937 (10). In preparing a trustee's accounting, what tests would you apply to determine whether a dividend duly declared by a corporation was an ordinary dividend to be credited to income, or an extraordinary dividend subject possibly to apportionment between income and principal?

The first test to be applied is whether the distinction between ordinary and extraordinary dividends is applicable to the particular trust. Such distinction is purely academic for

the purpose of apportioning the dividend between principal and income in a majority of the states where the so-called Massachusetts Rule, now embodied in the Uniform Principal and Income Act, prevails, namely, that all cash dividends, ordinary or extraordinary, are payable as income. (See sec. 1264, "Ordinary v. extraordinary cash dividends.")

In jurisdictions where the minority rule prevails, namely, that ordinary dividends are treated as income, but that extraordinary dividends are treated as principal or income depending, respectively, upon whether they were earned before or after the commencement of the life interest (sec. 1264), the following tests may be used in determining whether a cash dividend is ordinary or extraordinary: (1) whether similar dividends have been declared with regularity in the past, (2) whether such dividends are regularly paid out of current earnings, (3) the frequency with which such dividends are declared, (4) the size of the dividend in relation to the market value of the shares at the time of the creation of the trust, (5) the designation, if any, placed upon it by the directors of the corporation, and (6) the source of the earnings from which the distribution is made.

1825. NY Oct. 1936 (10). Does a cash dividend on stock, declared before a testator's death, payable to stock of record on a date subsequent to the testator's death, become a part of the estate or does it belong to the life tenant as income? Give the reason for your answer.

It belongs to the life tenant as income. See sec. 1820, subd. (a).

1826. NY Oct. 1942 (14). (a) In the law of trusts, what is the most common meaning of the term *accounting*?

(b) By whom is the accounting made, upon whose initiative is it made and to whom is it submitted?

(c) What period should be covered by an accounting?

(d) If more than one accounting is made, by what terms are they distinguished?

(a) The term *accounting* in the law of trusts signifies a proceeding wherein the fiduciary submits his account for judicial approval. (See sec. 1259.)

(b) The accounting is made by the trustee. It may be voluntary or involuntary. In the former case the trustee submits the accounting upon his own initiative; and in the latter, he is compelled by the Court to make it, either at the instance

of someone interested in the estate, or by the Court of its own motion. The accounting is submitted to the surrogate or probate court.

(c) The period covered by the accounting depends upon whether such accounting is intermediate or final.

An intermediate account is one made pending administration, filed on an annual or other recurrent basis, where a fiduciary continues to hold trust assets, or a trustee or general guardian continues to function during a period of infancy. Such accounts cover the particular period for which the account is made.

A final account is one rendered at the conclusion of the fiduciary's task. Such an account would incorporate the details of all transactions which have occurred from the last date covered by the intermediate account up to the date as of which the final account is being rendered.

(d) The terms in question are *intermediate* and *final*.

1827. AI Nov. 1943 (7). (a) Define a trust, the settlor, the trustee, the trust property, and the beneficiary.

(b) What are the duties of trustees with respect to accounts?

(c) With what will the trustee be charged on the accounting?

(d) What credits is the trustee entitled to?

(a) A trust is a confidence reposed in one person with respect to property held by him for the benefit of another.

The *settlor* of a trust (also known as the *donor*, *creator* and *founder*) is the person who creates or establishes a trust.

The trustee is the person in whom legal title to property is vested for the purpose of fulfilling the terms of a trust.

The trust property is the property which is entrusted by the donor or settlor to the trustee.

The beneficiary is the person for whose benefit the trust is created.

(b) A trustee must keep true and accurate accounts of his stewardship on behalf of the estate. He must make such accounts available for the inspection of the beneficiary at such reasonable times and under such reasonable circumstances as may be required, and he must render a report or accounting in respect to his accounts either on an intermediate or final basis (sec. 1826, subd. (c)). The trustee's accounts should show all trust property which originally came into his hands when the trust was established; all additions, increases and

accruals of principal; all sales of trust property and the proceeds thereof; the decrease in value of capital assets through natural or other causes, such as shrinkage in physical or market value, or losses from any cause; all trust income of whatsoever nature received by the trustee; all charges against income and principal; and all property remaining in the trustee's hands for which the trustee remains accountable.

(c) The trustee will be charged on the accounting with all property originally coming into his hands, all additions, increases or accruals thereon, all proceeds from the sale of trust property, all trust income of whatsoever nature received by the trustee and all property remaining in the trustee's hands.

(d) The trustee is entitled to credits for all trust property disposed of by sale or otherwise, the decrease in value of capital assets through shrinkage and losses, and all charges against income and principal, including all distributions made pursuant to the terms of the trust.

1828. NY Apr. 1938 (7). What is meant by "annual rests" in connection with estates? In an estate of considerable principal and large annual income, how do annual rests benefit the trustee?

"Rests are periodical balancings of an account (particularly in mortgage and trust accounts) made for the purpose of converting interest into principal, and charging the party liable thereon with compound interest."⁷

"An annual rest is a financial statement furnished to the persons interested in the estate. It is an informal manner of accounting to the interested parties. The account shows what occurred during the period which it covers. It is not judicially settled, nor does the accounting party receive a discharge as to the matters contained in it, but it serves as the basis for allowing commissions on income to the accounting party."⁸

Annual rests benefit the trustee or any other accounting party because "where annual rests are necessary to charge the party accounting with interest on the balances remaining in his hands, such accounting party is entitled to full commissions on each year's receipts and disbursements."⁹

⁷ *Black's L.D.*, Third Ed., 1547.

⁸ Dodge, *Estate Administration and Accounting*, p. 374. See also *Matter of Mason*, 98 N.Y. 527; *Matter of Martin*, 196 N.Y. 415.

⁹ *Hancox v. Meeker*, 95 N.Y. 528, 539.

CHAPTER XVI-A

Bankruptcy

1829. NY Oct. 1941 (7). (a) Compare or contrast the terms *bankruptcy* and *insolvency*.

(b) Compare bankruptcy laws and insolvency laws, explaining the differences, if any, between them.

* (a) *Bankruptcy* is a legal status. A person is not a bankrupt unless he has been so declared ("adjudicated") in a bankruptcy court. *Insolvency*, on the other hand, is a financial status. It has two meanings. In the state or equity sense of the term, it means inability to meet one's debts as they mature. Under the Bankruptcy Act, however, a person is insolvent if the aggregate value of his assets is not, at a fair valuation, sufficient to pay his debts. (See sec. 1281.)

(b) There are numerous insolvency laws but there is only one Bankruptcy Act. The essence of a bankruptcy law is to compel a debtor to surrender his assets for the benefit of his creditors and to afford him a discharge at the end of a court proceeding if he has fully complied with the law. State laws may compel a debtor to surrender assets in individual cases, either upon an attachment or in execution of a judgment (sec. 73), but they may not compel a debtor to make an involuntary surrender of all his assets for the general benefit of all his creditors; neither may they grant a debtor a statutory discharge from all his debts. These are bankruptcy functions that the United States Constitution vests exclusively in the Federal courts.

1830. AI May 1942 (7). (a) What constitutes insolvency under the National Bankruptcy Act?

(b) What other definition of insolvency is sometimes used in state statutes?

(c) How does a referee in bankruptcy obtain his official position and what in general are his duties?

(d) How does a trustee in bankruptcy obtain his official position and what in general are his duties?

(e) What is the effect of a discharge in bankruptcy?

(a) See sec. 1829, subd. (a).

(b) See sec. 1829, subd. (a).

(c) Referees in bankruptcy are appointed for a term of two years by the judge of the United States District Court. The referee is both a judicial and administrative officer. The judge before whom a bankruptcy matter is brought may refer it either *generally* or *specially*, and either before or after adjudication. On a general reference, the referee has complete jurisdiction of the proceedings. (For further detail as to a referee's judicial functions and for a specification of his administrative duties, see sec. 1282.)

(d) A trustee in bankruptcy obtains his official position through election by creditors at their first meeting (sec. 1306). Primarily, the trustee's function is to collect and reduce to money, under the direction of the Court and as expeditiously as possible, all property, real or personal, tangible or intangible, that may belong to the bankrupt, wherever such property may be located and whoever may be in possession of it. All other duties of the trustee are subordinate and incidental to this one. (The trustee's specific duties are set forth in detail in sec. 1307.)

(e) The effect of a discharge in bankruptcy is to release the bankrupt of all civil obligations that are provable in bankruptcy, except as to claims that are not dischargeable. (See sec. 1345.)

1831. NY Apr. 1943 (9). A holds two notes, each due today and each for \$100,000 but made by two different persons as follows:

X, whose assets, all frozen, have a fair value of \$1,000,000.

Y, whose assets, all liquid, have a fair value of \$90,000.

(a) Is X or Y, or both, insolvent? Explain.

(b) Is X or Y, or both, bankrupt? Explain how and when.

(c) By what law is bankruptcy regulated in this state?

(a) Under the Bankruptcy Act, X would be solvent, but not Y. The aggregate value of X's assets is sufficient, at a fair valuation, to pay his debts. This is not true as to Y. (See sec. 1281.)

(b) Neither X nor Y is bankrupt. A person is not a bankrupt unless he has been so declared ("adjudicated") in a bankruptcy court.

(c) Bankruptcy in every state of the Union is regulated by the National Bankruptcy Act.

1832. AI May 1935 (11). (a) Who may become a voluntary bankrupt?

(b) Who may be adjudged an involuntary bankrupt?

(c) Name at least four acts of bankruptcy.

(a) Any person (except a municipal, railroad, insurance or banking corporation, or a building and loan association) may file a voluntary petition in bankruptcy. He becomes a voluntary bankrupt upon filing such petition.

(b) Any natural person (except a wage earner or farmer) and any moneyed, business or commercial corporation (except a building and loan association, or a municipal, railroad, insurance or banking corporation) owing debts to the amount of \$1000 or over, may be forced into involuntary bankruptcy upon committing an act or acts of bankruptcy (sec. 1291). If a petition is filed against any person or corporation other than those specified, it will be dismissed; for example, a petition against a railroad corporation.

(c) The six acts of bankruptcy are as follows (for explanation see secs. 1292-1297):

(1) Transferring or concealing one's property or permitting it to be transferred or concealed, with intent to "hinder, delay or defraud his creditors."

(2) Giving a preference while insolvent.

(3) Permitting a creditor to obtain a lien, while insolvent.

(4) Making a general assignment for the benefit of creditors.

(5) While insolvent or while unable to pay debts as they mature, procuring, permitting or suffering, voluntarily or involuntarily, the appointment of a receiver or trustee to take charge of one's property.

(6) Admitting in writing one's inability to pay his debts and his willingness to be adjudged a bankrupt.

1833. NY Apr. 1940 (2). (a) Who may become a voluntary bankrupt?

(b) By whom may an involuntary petition in bankruptcy be filed?

(c) What are acts of bankruptcy?

(a) See sec. 1832, subd. (a).

(b) Three or more creditors who have provable claims against any person amounting in the aggregate (in excess of the value of any security held by them) to \$500 or over, may file an involuntary petition. If the combined number of creditors is less than twelve, any one of such creditors whose claim equals \$500 net, in excess of securities, may file the petition.

(c) See sec. 1832, subd. (c).

1834. NY Oct. 1935 (14). A person is insolvent but refuses to make an assignment for the benefit of creditors or to take any other action. In what way, if any, can his creditors bring about a distribution of his assets among them?

The creditors can bring about a distribution of the insolvent's assets by filing a petition in bankruptcy against the insolvent person. To obtain an adjudication, the creditors would have to show not only that the person was insolvent, but likewise that he had committed an act of bankruptcy. (See sec. 1291.) A distribution of the insolvent's assets can then be procured through dividends in bankruptcy out of the bankrupt estate.

1835. NY Oct. 1937 (6); NY Apr. 1935 (7). What are considered acts of bankruptcy under the National Bankruptcy Act?

See sec. 1832, subd. (c).

1836. AI May 1944 (11). (a) In bankruptcy, how is the trustee selected?

(b) In the case of bankruptcy of the individual partners and also the partnership, how are the estates of the partnership and the individual partners distributed?

(c) In the case of bankruptcy, to what extent are stockholders and officers of a corporation personally liable?

(d) What right does the trustee in bankruptcy of the insured take in his life insurance policy?

(a) A trustee in bankruptcy is elected by the creditors who have filed their proofs of claim, at their first meeting, by the vote of a majority in number and amount (except that claims of \$50 or less are counted in computing the amount but not in computing the number of creditors voting).

(b) In the administration of a bankrupt partnership estate, the Bankruptcy Act recognizes the rule of marshaling assets. Firm assets must first be made available for the payment of firm debts, and the partners' individual assets for the payment of their respective individual debts. If, after payment of firm debts, a surplus remains, such surplus—in which each individual partner has an undivided interest—may be applied to the payment of the partners' individual debts. If, after a partner pays his personal debts out of his personal assets, a surplus remains, such surplus may be applied to the payment of firm debts, provided firm assets are insufficient for this purpose.

(c) In the case of bankruptcy, stockholders and officers of a corporation are personally liable for any wrongs to the corporation that would give the corporation redress against such

stockholders or officers. (See secs. 865, 814-817, 819 and 821-824.)

(d) The rights of a trustee in bankruptcy in connection with insurance policies depend upon whether the policy covers property or life. A bankrupt's property insurance forms part of his estate, and the trustee acquires all rights of the bankrupt in respect thereto. As to life insurance, the rule is not uniform. To determine the bankrupt's rights in respect to life insurance, it is necessary to consider whether the bankrupt is himself a policy holder, thus having an interest in the cash surrender value of the policy, or whether he is the beneficiary under a policy insuring the life of another. Even with this distinction, the rule varies in the different states.

1837. NY Oct. 1938 (8). (a) What is meant by a proof of claim in bankruptcy?

(b) When and with whom must it be filed?

(c) Mention five provable debts from which a bankrupt is not released by a discharge in bankruptcy.

(a) A proof of claim in bankruptcy is a statement under oath, in writing, signed by a creditor, setting forth the claim, the consideration therefor, whether any securities are held for such claim and if so, what, whether any payments have been made on the claim and if so, what, together with an affirmation that the sum claimed is justly owing from the bankrupt to the creditor.

(b) Proofs of claim must be filed within six months after the first date set for the first meeting of creditors. They may be filed in the bankruptcy court where the proceedings are pending or before the referee if the case has been referred.

(c) *Ten* provable debts from which a bankrupt is not released by a discharge in bankruptcy are:

(1) Taxes.

(2) Liabilities for obtaining money or property by false pretenses or representations.

(3) Liabilities for willful and malicious injuries to the person or property of another.

(4) Liabilities for alimony due or to become due.

(5) Liabilities for maintenance or support of a wife or child.

(6) Liabilities for seduction, or for breach of promise of marriage accompanied by seduction, or for criminal conversation.

(7) Debts not scheduled by the bankrupt, owed to a creditor ignorant of the bankruptcy proceedings.

(8) Debts created by the bankrupt's fraud, embezzlement, misappropriation or defalcation while acting as an officer or in any fiduciary capacity.

(9) Debts due for wages that have been earned within three months before the date of commencement of the bankruptcy proceedings.

(10) Debts due employees for monies deposited by them as security for faithful performance.

(For further detail, see sec. 1345.)

1838. NY Oct. 1943 (6). *A* and *B* are both doing business in the course of which each has an open account against the other, when *B* is adjudged a bankrupt.

(a) Is *A* liable for the amount he owes to *B*, and does *A* become a general creditor of *B*?

(b) Can *A* apply *B*'s indebtedness to him, *A*, in reduction of his, *A*'s, indebtedness to *B*?

(c) What principle of law is involved in this situation?

(a) *A* is liable for the amount he owes *B*, and *A* becomes a general creditor of *B*. "In all cases of mutual debts or mutual credits between the estate of a bankrupt and a creditor the account shall be stated and one debt shall be set off against the other, and the balance only shall be allowed or paid."¹

(b) *A* can apply *B*'s indebtedness in reduction of his own indebtedness to *B*.

(c) See subd. (a), above.

1839. NY Apr. 1938 (8). Where a customer has paid by check and, before the check had been presented at the bank for collection, the customer had become bankrupt, has the recipient of the check (payee) any preferred claim on the assets of the bankrupt, or does he share with the general creditors? Explain.

The recipient of the check has no preferred claim on the assets of the bankrupt, but shares with the general creditors. A check is merely an order, drawn by a creditor of a bank upon the latter, requesting the bank to pay to the order of the person named as payee a sum certain in money on demand. Until such order is honored—either by payment, or by acceptance (certification), or by the constructive application of the funds to the credit of the payee (as by crediting the proceeds to the payee on the books of the corporation)—no equitable assign-

¹ Bankruptcy Act, sec. 68.

ment of the fund takes place, and the payee is unable to establish a specific claim upon the amount represented by the check.

1840. NY Apr. 1939 (14). Prior to becoming insolvent, the X corporation occupied a whole floor of a large building under a five-year lease. After the firm had become insolvent, the receiver in bankruptcy disaffirmed the lease, which had three years to run, and vacated the premises.

(a) How and under what act can the landlord claim rent for all or part of the balance of the lease?

(b) Is the bankrupt corporation relieved from its debt on the unexpired lease?

(a) The landlord may claim rent by filing a proof of debt with the referee in bankruptcy under sec. 63 of the Bankruptcy Act. The disaffirmance of the lease by the receiver is treated as a breach of contract and constitutes a provable debt.

(b) The bankrupt corporation is only partly relieved from its debt on the unexpired lease. The landlord's right to treat the receiver's disaffirmance as a breach of contract is subject to the proviso: "That the claim of a landlord for damages for injury resulting from the rejection of an unexpired lease of real estate or for damages or indemnity under a covenant contained in such lease shall in no event be allowed in an amount exceeding the rent reserved by the lease, without acceleration, for the year next succeeding the date of the surrender of the premises to the landlord or the date of reentry of the landlord, whichever first occurs, whether before or after bankruptcy, plus an amount equal to the unpaid rent accrued, without acceleration, up to such date."²

1841. AI May 1940 (7). A person occupying premises under a lease files a petition in bankruptcy four years prior to the termination of the lease and immediately vacates the premises. What are the landlord's rights and what should he do to protect them?

The landlord has a claim for rent due and unpaid at the time of the tenant's bankruptcy. The provability of his claim for future rentals for the unexpired period will depend upon the language of the lease and any forfeiture provisions thereunder (see sec. 1335). Should the trustee in bankruptcy disaffirm the unexpired lease, such disaffirmance may be treated by the landlord as a breach of contract, that constitutes a provable claim. However, the maximum damage which a landlord may claim in such cases, regardless of how much longer the lease still has to run, is limited to a year's rent from the date of sur-

² *Bankruptcy Act*, sec. 63, subd. a (9). ♦

render of the premises or re-entry by the landlord (whichever occurs first), plus rent previously accrued.

1842. NY Apr. 1942 (2). (a) List five debts that have priority in bankruptcy.

(b) List five debts from which a bankrupt is not released.

(a) Six debts that have priority in bankruptcy are: (1) Actual and necessary costs and expenses of preserving the estate; (2) wage claims; (3) costs and expenses of creditors for successfully opposing, revoking or setting aside a plan of arrangement, or a wage earner's plan (sec. 1352), or a bankrupt's discharge, or in securing the conviction of any person for a bankruptcy offense; (4) tax claims; (5) debts entitled to priority by Federal and state laws; and (6) debts contracted after the granting of a discharge or after the confirmation of an arrangement, where the discharge or confirmation is subsequently revoked or set aside for fraud or similar reason. (For further details, see sec. 1334.)

(b) See sec. 1837, subd. (c).

1843. NY Oct. 1940 (12). At the audit of trustee's final account, the following claims are made. State the proper order of priority.

(a) Taxes due the United States.

(b) Taxes due New York State.

(c) Receiver's commission.

(d) Claim of the United States for damages for breach of contract.

(e) Claim of merchandise creditors for value of merchandise sold upon false representations as to financial responsibility.

(f) Trustee's attorney's fees.

(g) Referee's costs and commissions.

First in priority would come the referee's costs and commissions. Without court costs and fees there could be no bankruptcy administration, hence no distribution in bankruptcy.³ Similarly, the receiver's commission and trustee's attorney's fees, as administration expenses, would be accorded top priority in distribution. Next would come taxes. No distinction would be made between Federal and New York taxes. "The Bankruptcy Act is construed to place all taxes due the United States, state, county, district, or municipality, in one and the same class and not to confer or contemplate any right of priority among the various taxing districts."⁴ Then would come

³ *Little v. Peyton*, 54 Fed (2d) 678 (D.C., La.); *In re Caswell Const. Co.*, 13 Fed. (2d) 667 (D.C., N.Y.).

⁴ 8 *Corpus Juris Secundum* 1330, citing *State of Missouri v. Ross*, 299 U.S. 72. However, a tax that is a lien has priority over a tax that is not a lien.

the fraud claims of merchandise creditors and the breach of contract claim of the United States—both groups as general creditors, without priority between them.⁵

1844. NY Oct. 1936 (14). Mention three differences between a dividend paid by a corporation and a dividend paid by a trustee in bankruptcy.

See sec. 1670.

1845. AI-NY May 1945 (12). (a) Name and describe *four* types of claims against a bankrupt that are not discharged in bankruptcy.

(b) A person is insolvent but refuses to make an assignment for the benefit of creditors or to take any other action.

(1) In what way, if any, can his creditors bring about a distribution of his assets among them?

(2) Is insolvency alone sufficient for this purpose?

(3) Can such proceedings be taken against all debtors? Are there any exceptions? If so, name them.

(c) The Amalgo company holds a note of the Crockett company for \$2500. This note is secured by collateral worth \$1800. The Crockett company goes into bankruptcy. The trustee expects to pay creditors forty cents on the dollar. How much is this note held by the Amalgo company worth?

(d) Name and describe *three* differences between a dividend paid by a trustee in bankruptcy and an ordinary dividend paid by a corporation.

(a) See sec. 1842, subd. (b).

(b) (1) If the person in question has committed an act of bankruptcy, creditors may bring about a distribution of his assets by filing an involuntary petition in bankruptcy against him.

(2) Insolvency alone is not sufficient for this purpose. The debtor must have committed an act of bankruptcy.

(3) Such proceedings cannot be taken against all debtors. The following exceptions are specified in the Bankruptcy Act:

(1) Wage earners, (2) farmers, (3) building and loan associations, (4) municipal corporations, (5) railroad corporations, (6) insurance corporations and (7) banking corporations.

(c) The note is worth \$2080, i.e., the value of the collateral (\$1800) plus 40% of \$700, the unsecured portion of the claim, or \$280, making a total of \$2080.

(d) See sec. 1670.

⁵ It should be noted, however, that creditors who are induced by a bankrupt's fraudulent representations to sell him goods may bring reclamation proceedings (sec. 1330) by rescinding the contract because of the fraud, instead of, as here, filing a claim for the value of the merchandise. Had the creditors done that, their claims would have ranked ahead of all others.

1846. NY Oct. 1936 (13). Mention *four* claims against a bankrupt that are not affected by his discharge in bankruptcy.

See sec. 1837, subd. (c).

1847. AI May 1943 (4). (a) For what purpose or reason does the Bankruptcy Act except from the operation of a discharge a provable debt that had not been duly scheduled in time for proof and allowance, unless the creditor had notice or actual knowledge of the proceedings in bankruptcy?

(b) When is a person deemed insolvent within the provisions of the Bankruptcy Act?

(c) Is a creditor who holds property of a third person as security for a claim against a bankrupt a secured creditor under the Bankruptcy Act?

(a) The reason for exempting debts not duly scheduled is that if such debts were dischargeable, a creditor might have no recourse on his claim. Unless he was notified of the bankruptcy proceeding in time to file his claim, he might learn of it too late and, if the debt were then discharged in bankruptcy, he would have no recourse against the bankrupt.

(b) See sec. 1829, subd. (a).

(c) No. A secured creditor is defined by the Act⁶ as one who has security on the *property of the bankrupt*, or who owns such a debt for which "some endorser, surety, or other person secondarily liable for the bankrupt has such security upon the bankrupt's assets." (For examples, see sec. 1332.)

1848. AI Nov. 1938 (6). List or enumerate, but do not discuss, the provisions in the bankruptcy law that became effective September 22, 1938, concerning plans of corporate reorganization, stating with what a plan may deal, for what it may and for what it must provide, and what it must specify.

The general provisions of the Bankruptcy Act of 1938 concerning plans of corporate reorganization, stating with what a plan may deal, for what it must provide and what it must specify, are set forth in sec. 1351. Among the optional provisions of a plan of reorganization are the following:

(1) *Modification in rights of stockholders.* The plan may include, as to stockholders generally, or some class of them, provisions altering or modifying their rights, either through the issuance of new securities, or otherwise.

(2) *Property affected.* The plan may deal with all or any part of the debtor's property.

(3) *Rejection of executory contracts.* The plan may provide for the rejection of any executory contract, except contracts in the public authority.

(4) *Retirement of long-term indebtedness.* Where the plan creates or

⁶ Sec. 1, subd. 28.

extends an indebtedness for a period of more than five years, it may provide for a sinking fund to retire such indebtedness.

(5) *Claims belonging to debtor or estate.* The plan may include provisions for the settlement or adjustment of claims belonging to the debtor or the estate.

(6) *Other provisions.* The plan may include any other provisions not inconsistent with the rest of the Act.

1849. AI May 1936 (11). Give a general description of the plan provided in section 74 of the national bankruptcy act that makes it possible for a person, other than a corporation, in financial difficulty to petition for a composition with creditors or for an extension of time in which to pay his debts.

Sec. 74 of the Bankruptcy Act, in force in 1936, has been superseded by Chapter XI of the present Act, providing for Arrangements. (See sec. 1352.)

1850. NY Apr. 1939 (8). (a) What is a *composition*?

(b) When may a bankrupt offer a composition and to whom?

(c) When is such offer effective?

(d) For what reasons may a composition be denied?

(e) If a composition is allowed, what is the effect on the proceedings?

Compositions in bankruptcy under secs. 12 and 13 of the old Bankruptcy Act have been superseded by Chapters X, XI, XII, XIII and XIV of the present Act. Chapter X deals with Corporate Reorganizations, Chapter XI with Arrangements for compositions, settlements and extensions generally, Chapter XII with Real Property Arrangements by individuals, Chapter XIII with Wage Earners' Plans for financial rehabilitation, and Chapter XIV with Maritime Commission Liens.

Chapter XI of the present Act, dealing with compositions, settlements and extensions generally, provides a broader means whereby debtors may arrange settlements, compositions or extensions with creditors. Arrangements are open not only to individuals and partnerships but to corporations as well. Insolvent corporations seeking relief must now apply for an arrangement instead of a corporate reorganization, the latter being available only to a solvent corporation seeking to recast its capital structure, in other words, seeking relief as to its investors, instead of its creditors.

A debtor, to seek an arrangement, need not be insolvent under the definition of the Bankruptcy Act (excess of liabilities over assets). Inability to pay debts as they accrue, regardless of total assets and liabilities, is sufficient.

Arrangements are available not only to debtors by an orig-

inal petition but also to debtors already in bankruptcy, either before or after adjudication.

Debtors must submit a definite plan with their petition for an arrangement and may be required to file a bond protecting creditors against loss that may be suffered by reason of the proceeding, should it fail. Consents to the proposed "arrangement" may be obtained before the filing of a petition.

Provision is made under the present Act for continuation, pending an arrangement, of the debtor's business under the control of a creditor's committee, either with or in the place of a receiver.

CHAPTER XVII

Unclassified

1851. AI Nov. 1939 (12). Define briefly:

- (a) Slander.
- (b) Libel, as distinguished from slander.
- (c) Equity, as distinguished from common law.
- (d) Bailment.

(a) Slander is oral defamation of one person by another in the hearing of a third person or persons.

(b) Libel is written or printed defamation of one person by another, published before a third person or persons. The distinction between slander and libel is in the defamatory medium, the former being by the spoken, the latter by the written or printed word.

(c) Equity is that branch of the unwritten law, founded in justice and fair dealing, that seeks to supply a more adequate remedy than that available at common law. (See sec. 8 for further discussion.)

(d) See secs. 453 and 1527.

1852. NY Apr. 1938 (9). Define the following: (a) replevin, (b) garnishment, (c) chattels, (d) tangibles, (e) fungible commodities.

(a) *Replevin* is an action brought to recover possession of goods wrongfully taken or detained.

(b) *Garnishment* is a proceeding by which it is sought to apply in satisfaction of a judgment, wages, salaries and any other monies or property due the judgment debtor from a third party.

(c) *Chattels* are articles of personal property. (The term "chattel" is a corruption of the word "cattle," which at one time served as the measure of a person's wealth.)

Chattels may be *real*, as where they relate to land (examples, *leases* and *mortgages*), and *personal*, as in the case of personal property unrelated to lands.

(d) *Tangibles*, literally, are things that can be *touched*,

as distinguished from *intangibles*, or things that cannot be touched.

In the field of real property, tangibles embrace lands and things permanently annexed to lands. Such interests are sometimes said to be *corporeal* (literally, having body, or substance). A common example of an intangible or incorporeal interest in real property is an *easement*, such as a right of way or a right to light, air and access.

In the field of personal property, tangibles include all things physical, such as money, gold, silver, merchandise and all other forms of personal property that are susceptible to physical possession. Hence, such chattels are known as *choses* (things) *in possession*. Intangible personal property embraces all things personal that are not susceptible to physical possession and that require some form of action to reduce them to possession. Hence, they are known as *choses in action*. Examples are contracts, promissory notes, checks, trade acceptances, bonds, stocks, bank accounts, and so on.

(e) *Fungible commodities* are commodities consisting of a uniform mass, no part of which can be ascertained or sold except by weight or measure. Examples are peas, beans, bricks, sand, wine, oil, gasoline, wheat, corn, oats, barley and flour.

1853. NY Apr. 1936 (2). Define (a) bailment, (b) pledge, (c) guaranty, (d) deed, (e) abstract of title.

(a) See secs. 453 and 1527.

(b) See secs. 471 and 1537.

(c) A guaranty is an undertaking to answer for the debt, default or miscarriage of another. Debt refers to money obligation, default to breach of contract obligation, and miscarriage to breach of some duty. (For distinctions between guaranty and suretyship, see secs. 904 and 1689.)

(d) See secs. 1043 and 1735, subd. (b) (3).

(e) See secs. 1046 and 1739, subd. (a).

1854. AI Nov. 1935 (5). (a) Define *personal property*.

(b) Define *tangible* and *intangible*.

(c) Define *lien*.

(d) Define *pledge*.

(e) What are the usual ways by which title to personal property is acquired?

(a) Broadly speaking, personal property is all property not fixed or immovable. It has been defined as "everything that is

the subject of ownership, not coming under denomination of real estate," or "a right or interest in things personal, or right or interest less than a freehold in realty [sec. 1028], or any right or interest which one has in things movable."¹

(b) See sec. 1852, subd. (d).

(c) A lien is a charge imposed on property by which the property is made security.

(d) See secs. 471 and 1537.

(e) Title to personal property may be acquired by act of parties and by operation of law.

(1) *Act of parties*: Title to personal property may be acquired by act of parties through:

(i) Appropriation (sec. 1077)

(ii) Discovery (sec. 1078)

(iii) Creation (sec. 1079)

(iv) Gift (secs. 1080-1082)

(v) Sale or exchange (Chap. IV)

(vi) Will (Chap. XIV)

(2) *Operation of law*: Title to personal property may be acquired by operation of law through:

(i) Death intestate (sec. 1179)

(ii) Bankruptcy (Chap. XVI)

(iii) Legal process, as by levy and sale under execution of a judgment (sec. 73)

(iv) Marriage (in states that substitute an out-and-out distribution to the surviving spouse of personal as well as real property in lieu of the common law rights of dower and curtesy, which apply to real property only). See secs. 1042 and 1179.

1855. NY Apr. 1937 (6). (a) To what classes of business organizations does the term *limited liability* apply?

(b) State generally its application in each case.

(c) Mention the exceptions, if any, to the general rule.

(a) The term *limited liability* applies to *limited partnerships* and to *business corporations*.

(b) Limited partners as such are not personally bound by the obligations of the firm. Only their capital contributions are subject to the claims of firm creditors. In other words, the maximum liability of a limited partner is measured by the

¹Black's L. Dic. Third Ed., 1447.

amount of his investment. Similarly, a stockholder of a business corporation is not liable for the debts of the corporation except to the extent of his investment; that is, he may lose what he has paid for his stock, but that is all.

(c) *Limited partnerships.* A limited partner may become liable as a general partner (1) if he takes part in the control of the business or (2) if he permits his surname to be used in the firm name.

Business corporations. A stockholder of a business corporation may become liable:

(1) To the corporation (sec. 865) on:

(i) Unpaid stock subscriptions

(ii) Original issue stock issued for less than full value, where the corporation is not barred by illegality, estoppel or waiver

(iii) Dividends unlawfully received

(2) To judgment creditors of the corporation (sec. 866) for:

(i) Unpaid stock subscriptions

(ii) Stock issued for less than value (watered stock)

(iii) Dividends unlawfully received

(3) To wage earners (sec. 867).

(4) To unpaid creditors in a state other than that of incorporation, where business is being done without complying with the state laws governing foreign corporations (sec. 876).

1856. NY Apr. 1940 (15). (a) Name the different types of negotiables that are customarily treated as cash, that is, as current funds.

(b) Name the different types of negotiables that should not be treated as cash.

(c) Define *collateral security*.

(d) Must collateral security be negotiable?

(e) In whom is (1) the legal title to collateral, (2) the equitable title?

(a) Negotiables customarily treated as cash, or current funds, include: (1) Undeposited demand instruments, such as undeposited checks, drafts, money orders and trade acceptances, (2) travellers' checks and (3) cashier's checks.

(b) Negotiables that should not be treated as cash are: (1) Negotiable documents of title, such as bills of lading and warehouse receipts, (2) letters of credit, (3) promissory notes, (4) time drafts, (5) time trade acceptances and (6) post-dated checks.

(c) Technically, *collateral security* is any form of pledge

accompanying and securing a debt. By common usage, the term has come to mean stocks and bonds deposited to secure a debt.

(d) Except in specific situations that may be covered by statute, collateral security need not be negotiable. Thus, stocks and registered bonds, which are not negotiable in the legal sense of the term, are frequently deposited as collateral for a loan.

(e) (1) The legal title to collateral is usually in the pledgee, by virtue of a blank assignment (sec. 475). Such title is for purposes of security only. (2) The equitable title remains in the pledgor.

1857. NY Oct. 1943 (10). (a) Can two persons deposit money in a bank in such a way that, upon the death of either, the fund will pass to the other without probate?

(b) Can husband and wife, upon a sale of realty, take back a mortgage jointly so that, if one dies, the title will rest wholly in the survivor?

(c) If property owned jointly is income-producing, which of the parties should report the income therefrom on his United States income tax return?

(d) Is the former interest of a deceased party in a property owned jointly to be included in his estate for the purpose of the United States estate tax?

(a) Joint bank accounts cannot be established so as to pass title to the survivor without probate. Jointly owned property, including joint bank accounts, must be listed in the decedent's schedules for estate tax purposes. If any part of the property or fund was supplied by the survivor, only the decedent's interest is taxable.

(b) Yes, subject to tax on the decedent's interest.

(c) If income-producing property is owned jointly by husband and wife, they may file a joint return, or each may file a return for his or her share. If the joint tenants are not husband and wife, each must file a separate return for his share of the income, and, in addition, a partnership return must be filed for the entire interest.

(d) Yes. See subd. (a) above.

1858. AI Nov. 1940 (1). On October 1, a certified public accountant entered into a legally valid contract with a corporation whereby he agreed to audit the corporation's books for the year ending December 31, next, his work to begin December 1. On November 15, the accountant learned that the corporation had become insolvent after October 15. On November 20, a stockholder of the corporation, who was neither an officer nor a director of it, orally promised the accountant that if the accountant would make the

audit, the stockholder would pay the accountant's fee if the corporation did not pay it. The accountant made the audit to the satisfaction of everyone concerned, but the corporation failed to pay his fee. State every principle of law that would have a favorable or an adverse bearing on the accountant's right to enforce the stockholder's promise to pay the fee, and explain how the principle is applicable. You need not express an opinion with respect to the stockholder's legal liability.

The principles of law raised by this problem and their applicability to the facts, are as follows:

(1) The fulfillment of an existing duty, such as a pre-existing contract obligation, represents no sacrifice of a right, hence does not constitute consideration (sec. 153). The accountant's promise to fulfill his pre-existing contract obligation to render the services would furnish no new consideration to support the stockholder's promise to pay if the corporation did not. (Unfavorable.)

(2) If the pre-existing contract obligation had been discharged or excused by the fact of the corporation's insolvency, a promise to render the services notwithstanding would represent a sacrifice, hence constitute consideration for the stockholder's promise to answer for the corporate obligation. However, in the absence of express provision in the contract to the contrary, the mere fact of the other party's insolvency, without adjudication in bankruptcy or such other definite repudiation as would constitute an anticipatory breach, will not excuse performance. So long as the corporation had not failed to comply with any part of its contract with the accountant prior to the rendering of services, the accountant would be obliged to perform the services. Hence, a promise by the accountant to render the services would constitute a promise to discharge a pre-existing obligation and this would not supply consideration to support the stockholder's promise to make good the corporate obligation. (Unfavorable.)

(3) If one person promises to pay for services rendered to another, the question whether the services are beneficial to the promisor is immaterial. Consideration need not benefit the promisor, so long as it represents a sacrifice by the promisee (sec. 146). Hence, if the corporation failed to pay and the accountant sought to hold the stockholder on his promise, it would be no defense to the stockholder that his promise was not supported by consideration in that the services were of no benefit to him. Sacrifice by the promisee (accountant) in

reliance upon the stockholder's promise would constitute consideration to support such promise. (Favorable.)

(4) A stockholder promising to answer for a corporate obligation is in the position of one person agreeing to answer for the debt of another. A corporation, in the eyes of the law, is an artificial person, separate and distinct from its stockholders. A promise to answer for another must be in writing under the statute of frauds (sec. 917). The stockholder's promise was oral. (Unfavorable.)

(5) Where the promise to answer for another benefits the promisor, it constitutes an original undertaking rather than a guaranty and is binding without a writing (sec. 921). Thus, if the stockholder were benefited directly by his promise, such promise would be binding though oral. (Favorable.)

(6) However, in order that a promise to answer for another shall constitute an original agreement, binding without a writing, the benefit to the promisor must be direct, not indirect (sec. 921). The benefit accruing to a stockholder from a corporate benefit is indirect. Hence, the stockholder's promise constitutes a guaranty, not an indemnity, and must be evidenced by a writing. (Unfavorable.)

1859. NY Oct. 1943 (14). A manufacturer owes \$10,000 to a corporation from which he buys some of his materials. The account is overdue, but he is short of funds and asks his creditor to accept two notes for \$5000 each, due in three and six months respectively. He offers to give the creditor as security for the notes either (a) warehouse receipts for a particular class of materials that the creditor knows are valued at \$20,000, (b) unlisted bonds due in 1950, issued by a small industrial, with the unmatured coupons with a par value of \$15,000, (c) listed stock of another corporation with a market value of \$12,500 or (d) the indorsement of a man reported to be wealthy.

If you were the treasurer of the creditor corporation, what information would you want as to each form of security?

The treasurer should require the following information:

(a) Were the warehouse receipts negotiable or nonnegotiable? Negotiable warehouse receipts are more readily disposed of than nonnegotiable receipts. The treasurer should further verify the debtor's title to the warehouse receipts and should ascertain whether the goods represented by the receipts are marketable and saleable, also whether they are insured.

(b) The question whether the bonds are negotiable or nonnegotiable should be determined, since their negotiability

would facilitate liquidation in case of nonpayment of the notes. For example, if they are bearer bonds rather than registered bonds, such fact would be pertinent in appraising their value as collateral. It would also be material to inquire whether the bonds are secured or unsecured by a specific mortgage or lien on specific property. The treasurer should inquire from trade and credit associations, banks and wholesale houses as to the credit standing and reliability of the issuing industrial concern, since the value of the bonds would be largely determined by the ability of the concern to meet them at their maturity and to pay the unmatured coupons in the interim. Financial statements should be required direct from the corporation, certified to by a certified public accountant. These statements should disclose, among other things, financial condition, working capital, volume of sales, and earnings.

(c) Ownership of the stock and its registration in the name of the borrower should be ascertained and verified. Dividend history in connection with the stock would give some indication of its value. The question whether the listed stock was active or inactive on the stock exchange would have a bearing on the readiness with which it could be disposed of as collateral in case of default.

(d) An indorsement is as good as the indorser. The report of the indorser's wealth should be verified by information similar to that referred to in (b) above. The genuineness of the indorsement should be verified.

1860. NY Apr. 1940 (8). (a) Name the principal functions for which a bank may be organized.

(b) May a state bank or trust company join the Federal Reserve System?

(c) In order to become a member of the Federal Reserve System, what subscription, if any, must a bank make to the capital stock of the Federal Reserve bank of its district?

(d) To what extent, if any, must or may a member bank carry insurance in the Federal Deposit Insurance Corporation?

(e) What activities, if any, are forbidden to banks?

(a) The principal functions for which a bank may be organized are: (1) To receive deposits payable on demand, (2) to make loans and discount commercial paper, (3) to buy and sell bills of exchange, (4) to make collections of commercial paper, (5) to issue bankers' acceptances and letters of credit, (6) to serve as depository for safe keeping, (7) to issue mortgage

notes and debentures against assignments and conveyances of property as part of a financing or refinancing transaction, (8) to make investments.

(b) Any qualified state bank, trust company or mutual savings bank may join the Federal Reserve System.

(c) Each member bank, on joining the Federal Reserve System, must subscribe to stock of the Federal Reserve bank of its district in an amount equal to 6% of its paid-up capital and surplus.

(d) All member banks must carry insurance with the Federal Deposit Insurance Corporation. The insurance reserve is provided through annual assessment at the rate of one-twelfth of 1% upon the average deposits of each insured bank.

(e) Banks are not permitted to hold real estate or invest in securities for industrial or commercial purposes or to engage in nonbanking functions, excepting land and buildings needed for the conduct of the banking business or acquired through mortgage foreclosure in due course of banking, and excepting businesses acquired in salvaging loans.

1861. AI May 1944 (7). (a) What is the legal relation of a depositor to his bank?

(b) Has the depositor legal title to the deposits in his bank?

(c) What right of setoff has a bank against the accounts of the depositor?

(d) Has the bank the right of setoff of its unmatured claim against the depositor's account?

(a) The legal relation of a depositor to his bank is that of creditor to debtor.

(b) A general depositor has no legal title to the deposits in his bank.

(c) and (d). A bank has no right of setoff against the accounts of the depositor unless the setoff is based on a *matured* claim against the depositor's account, or on an unmatured claim against a depositor in bankruptcy. (sec. 1336).

1862. NY Oct. 1941 (3). A manufacturer whose credit standing is good sells his products on long terms, not installments, and at certain seasons needs additional cash for his payrolls and purchases of materials.

(a) State three methods that his bank may suggest to him.

(b) State the advantages and disadvantages of each method to the bank and to the borrower.

(a) The bank may suggest:

(1) *A loan based on the borrower's note.* If the manufac-

turer's credit is good, the bank may be willing to lend the money on the borrower's note alone, reflecting confidence in the borrower's ability, integrity and prospects.

(2) *A loan based on customer's paper.* The manufacturer may have acquired customers' paper on the sale of his products, such as accepted drafts payable to the bank's order or trade acceptances payable to the manufacturer's order, with fixed maturities. These, indorsed by the manufacturer, may be deposited with the bank against an immediate credit to the manufacturer's account, less the prevailing discount.

(3) *A secured loan.* The security may consist of (a) documents of title, such as bills of lading and warehouse receipts, (b) trust receipts, (c) collateral security, (d) property liens or (e) assignment of accounts.

(b) *As to Method (1):* The advantage to the bank is merely that of a profit on a good credit risk. If the bank is a member of the Federal Reserve System and the note has a maturity not exceeding ninety days, the bank may, if it wishes, rediscount the paper with the Federal Reserve bank of its district. The disadvantage of such a loan to the bank lies in the fact that it is unsecured, and there is always the danger of a borrower's suffering a business reverse and becoming financially unable to pay the note. From the borrower's standpoint, the loan is advantageous because it leaves his assets unencumbered and sustains his high credit standing.

As to Method (2): The advantage to the bank lies in the fact that such paper is self-liquidating; that is, it is based on specific commercial transactions whose proceeds afford payment of the paper given in connection with such transactions. Moreover, the manufacturer, in offering such paper to the bank for loan or discount, would be required to indorse it, so that the bank would have the additional security of two-name paper. The disadvantage to the bank lies in the fact that the paper is really unsecured, notwithstanding the manufacturer's indorsement. The advantage to the manufacturer is similar to that in connection with Method (1) above.

As to Method (3): All forms of secured loans are of course more advantageous to the bank than unsecured loans. From the standpoint of the borrower, a temporary surrender of his documents of title works little disadvantage to him, since the bank, in such cases, becomes in effect an agent for collection

with the aid of the bills of lading or warehouse receipts. Trust receipts are an advantage to the borrower since they provide a device by which he may turn his pledged merchandise into cash, thereby enabling him to discharge his debt and realize any surplus remaining. Collateral security and property liens, to the extent that they encumber a borrower's assets, represent a distinct impairment of his credit standing. The assignment of one's accounts represents one of the most drastic methods of securing a loan; it deprives a business man of the right to collect from his customers until the loan is paid, and it broadcasts his financial infirmity to the trade.

1863. NY Apr. 1942 (7). (a) What is the limit in the amount of the loans that a bank organized under the laws of New York may make to one borrower?

(b) State the exceptions to the general rule.

(c) A state trust company takes a time note from a customer and credits the amount of the loan to the customer's regular checking account. May the customer transfer the balance of its checking account to another bank without payment of the loan? Explain.

(a) A bank organized under the laws of New York cannot make loans to any single borrower in excess of one-tenth of its capital stock, surplus fund and undivided profits.

(b) The limitation does not apply to government loans or investments in government bonds. Discounts to a single borrower on sound commercial paper and on secured loans may equal but not exceed 25% of the Bank's capital stock, surplus fund and undivided profits.

(c) The customer may transfer the balance to another bank without payment of the loan. The amount in the checking account is payable on demand, the customer's note is not. Until the customer's note is due, the bank has no claim or offset against the customer's account. (See sec. 1861.)

1864. AI May 1942 (10). (a) What class or classes of notes or other commercial paper may be rediscounted by a Federal Reserve Bank?

(b) What paper may not be rediscounted there?

(c) Are directors of national banks subject to money liabilities beyond those of directors in other corporations? Explain.

(d) What are the functions of the Federal Deposit Insurance Corporation?

(a) The Federal Reserve Act provides that upon the indorsement of any of its member banks with a waiver of demand, notice and protest by such bank, any Federal Reserve

bank may discount notes, drafts and bills of exchange arising out of *actual commercial transactions*, that is, notes, drafts, and bills of exchange issued or drawn for agricultural, industrial or commercial purposes, or the proceeds of which have been used or are to be used for such purposes. The Board of Governors of the Federal Reserve System has the right to determine or to define the character of the paper thus eligible for discount. Notes, drafts and bills admitted to discount under the provisions of this Act must, as a rule, have a maturity at the time of discount of *not more than 90 days*, but notes, drafts and bills drawn or issued for agricultural purposes, or based on live stock, and having a maturity not exceeding six months, may be discounted in an amount to be limited to a percentage of the capital of the Federal Reserve bank as fixed by the Governors of the Federal Reserve System.

(b) Paper ineligible for rediscount with the Federal Reserve bank includes:

(1) Notes, drafts and bills of exchange not arising out of commercial transactions.

(2) Commercial paper having a longer maturity than 90 days.

(3) Paper covering permanent or fixed investments of any kind, such as land, buildings or machinery, or for any other capital purpose.

(4) Paper for investments of a purely speculative character. The Federal Reserve Act specifically excludes from eligibility for rediscount, notes, drafts or bills issued or drawn for the purpose of carrying, or of trading in, stocks, bonds or other investment securities, except bonds and notes of the Government of the United States.

(5) Paper, the proceeds of which, though not used in the first instance for a speculative purpose, are to be used to finance relending operations in connection with which paper is not eligible for rediscount. This restriction shuts out the paper of finance companies that discount receivables or that finance installment sales.

(c) Directors of a national bank, unlike directors of most ordinary corporations, must become stockholders of the bank. As such, they were subject to double liability until such liability was abolished by Act of Congress contemporaneously with the establishment of the Federal Deposit Insurance Corporation.

In addition to the ordinary liabilities of directors for losses sustained by a corporation through their illegal, fraudulent or negligent acts, the banking statutes impose special liabilities on bank directors for banking irregularities, in view of the potential injuries that such irregularities may inflict on the general public.

(d) The more important functions of the Federal Deposit Insurance Corporation are:

(1) To pay deposit insurance in case of loss.

(2) To extend loans to, or purchase assets from, insured banks, in order to facilitate mergers or consolidations, reduce risks or avert threatened loss.

(3) To act as receiver for suspended banks.

(4) To make bank examinations of insured banks (in addition to the bank examinations by other examiners).

(5) To terminate the insurance of any bank that engages in unsound banking practices.

1865. NY Apr. 1937 (7). A manufacturer plans to get additional working capital from a Federal Reserve bank. Describe the necessary procedure, stating (a) to what person or organization he should apply, (b) what he should expect to deliver to the bank for the loan, (c) to what limitations his application must conform.

A manufacturer may procure a loan from a Federal Reserve bank only in exceptional circumstances. The Federal Reserve Act provides:² “In exceptional circumstances, *when it appears to the satisfaction of a Federal Reserve bank that an established industrial or commercial business located in its district is unable to obtain requisite financial assistance on a reasonable basis from the usual sources*, the Federal Reserve bank, pursuant to authority granted by the Board of Governors of the Federal Reserve System, may make loans to, or purchase obligations of, such business, or may make commitments with respect thereto, *on a reasonable and sound basis, for the purpose of providing it with working capital*, but no obligation shall be acquired or commitment made hereunder with a maturity exceeding five years.”

It will be noted that among the prerequisites for an industrial loan by a Federal Reserve bank, are the following: (1) That the borrower is an established industrial or commercial

²Sec. 352a, Loans for industrial purposes.

business located in the Federal Reserve district where the loan is sought, (2) that the borrower is unable to obtain the requisite financial assistance on a reasonable basis from the usual sources, (3) that the loan must be "on a reasonable and sound basis," (4) that the loan must be for the purpose of providing the borrower with working capital and (5) that the maturity of the obligation will not exceed five years. Therefore:

(a) The manufacturer should first seek a loan from "the usual sources"—meaning, as a rule, the local bank. If a loan cannot be thus procured on a reasonable basis, the manufacturer should then make application direct to the Federal Reserve bank in the district where the manufacturer's principal place of business is located. The application must, of course, be made in writing on a form furnished by the Federal Reserve bank, which form is designed to establish the basic conditions above noted in order to establish the exceptional circumstances for the making of a direct loan by the Federal Reserve bank.

(b) The manufacturer should expect to deliver to the bank for the loan such security as will comply with the above quoted requirement of the Federal Reserve Act that the loan be made "on a reasonable and sound basis." This would ordinarily include promissory notes or other evidences of the indebtedness in form prescribed by the Federal Reserve bank and such collateral security as may be deemed necessary in order to insure that the basis for the loan is reasonable and sound.

(c) The application must conform to such limitations as may be prescribed on forms that are designed to establish the prerequisites above mentioned to the making of a direct loan by a Federal Reserve bank to a commercial or industrial enterprise. Among the items of information that may be thus required are the following:

(1) General history and background of borrower, including nature and description of business, operations, information as to management, personnel, products dealt in, and so on.

(2) Commitment as to purposes for which borrower will expend proceeds of loan.

(3) Detailed description of and representations in respect to the collateral security offered.

(4) Financial information, including balance sheets, operating statements and reconciliations of surplus for the ten years

immediately preceding the date of application, or for the number of years since the establishment of the business if less than ten years.

(5) If borrower is a corporation, certified copies of certificate of incorporation and by-laws and resolution of board of directors authorizing the application for the loan. If the borrower is a partnership, a copy of the partnership agreement.

(6) Any appraisals, audits or other information that the Federal Reserve bank may deem necessary to insure that the loan is being made on a reasonable and sound basis.

1866. NY Apr. 1939 (7). (a) Under the banking law of New York State, what is the distinction between *surplus* and *surplus fund*?

(b) What is the purpose of the surplus fund and how is it created?

(a) A *surplus* is a book account, an excess of assets over liabilities. It may be, and often is, "frozen." A *surplus fund* is necessarily liquid. Being a fund, it may be resorted to for the purposes for which it was created. •

(b) The purpose of the surplus fund and the manner of its creation are set forth in the New York Banking Law:³ "Every bank and every trust company shall create a fund to be known as a surplus fund. Such fund may be created or increased by contributions, by transfers from undivided profits, or from net earnings. Such fund up to sixty-five per centum of the capital stock of the bank or trust company plus any amounts credited thereto in compliance with any requirement made by the banking board * * * shall not be available for the payment of dividends and may be used to pay expenses or absorb losses only in event such bank or trust company has no undivided profits against which such expenses or losses may be charged."

1867. AI May 1941 (3). Peters, a dealer in calculating machines, delivered to another dealer a small but expensive machine to show to customers and, if possible, to sell. Peters and the other dealer signed a statement reciting that the machine remained the property of Peters and stating that no sale would be effective until Peters had expressly approved it. Without Peters' knowledge, the other dealer sold the machine for cash to a public accountant who did not know and had no reason to infer that Peters was the owner of it, and then disappeared without accounting to Peters. Has Peters any rights against the public accountant?

Under the general rule applicable to sales by an agent or dealer apparently authorized to sell, Peters would have no

³Sec. 10.

remedy against the public accountant. When the owner entrusts possession of goods to an agent or dealer apparently clothed with authority to sell or to a person whose common business it is to sell, such as a factor or commission merchant (secs. 545, subd. (g), and 596), with instructions *not to sell* except upon prior approval, or subject to further directions, or upon some other condition, a sale by such agent contrary to instructions will not prevent title from passing to a purchaser in good faith and for value. This rule of law has been confirmed by statute in most of our states.

However, a Washington court has held that the owner of an automobile who delivered it to a motor company for sale on the owner's approval could recover it from one who purchased it from the company's salesman, and a New York court has applied a similar rule to a gem sold on memorandum. See, in this connection, the cases cited in sec. 405, subd. (a).

1868. NY Oct. 1940 (13). John Katz, a depositor in the Nickel Savings Bank, mailed his savings account passbook to the bank with a letter directing the bank to transfer the account, with accrued interest, to the account of his sister. The bank followed his instructions and wrote him a letter of confirmation. Although the bank did not know it, Katz was dead when the bank received the passbook and the letter of instructions.

(a) Is this a valid gift?

(b) Can the bank reverse Katz's instructions?

(a) This is not a valid gift, since it lacked delivery and acceptance (sec. 1080, subd. (d)). Delivery of Katz's passbook and letter cannot be construed as constructive delivery of the account, because when the bank received these, Katz was dead, and there can be no delivery, actual or constructive, on behalf of a dead donor. For the same reason, there could be no acceptance of such gift. Even if the bank could be assumed to have implied authority to accept on behalf of Katz's sister, it could not accept what it had no authority to deliver.

(b) The bank can neither effectuate nor reverse Katz's instructions, since such instructions were rendered ineffective by Katz's death. The bank may retransfer the account to the name of John Katz, as it may rectify any other error in the maintenance of its accounts with its depositors.

It should be noted that had these funds been paid out to the sister on presentation of the passbook after Katz's death but before the bank had a reasonable opportunity to ascertain the fact of such death, the bank would not have been liable to the

estate, but the sister would have been (sec. 385). However, authority of the bank to make such payment would have had to be founded on an actual gift of the passbook to the sister. In this connection, delivery of a savings bank passbook differs from delivery of a passbook of a commercial or checking account: the former, but not the latter, may constitute a valid delivery of the account. "The custody of a savings bank book is important in cases involving gifts for the reason that presentation of the book at the bank is essential in order to withdraw funds. An unqualified delivery of such a book from the owner to another with the intent to make a gift of the account is necessary to complete and validate such a gift. This is not true of a bank book of a commercial account subject to check. The book is not presented in order to withdraw funds. Delivery of the book from the owner to another will not constitute a gift. Custody of the book issued by a commercial bank is an immaterial matter. These observations assume cases in which the account is in the name of the depositor. The distinctions pointed out are found in *Brophy v. Haeberle*, 220 App. Div. 511, 221 N.Y.S. 698."⁴

1869. NY Oct. 1941 (11). On July 1, 1934, Ames gave Brown a negotiable demand note for \$1,000, with interest at 6% from July 1, 1935, and also delivered to Brown as collateral therefor securities having a market value of \$1,250. No payment on the note was ever made by Ames either for interest or on account of the principal. During 1937 the value of the securities shrunk to \$900 but later it rose and now (October 30, 1941) is \$1,100.

- (a) Can Brown recover and, if so, in what way?
- (b) What sections of Commercial Law are involved?
- (c) Explain fully your answers to (a) and (b).

(a) Brown can recover by selling the securities deposited as collateral and applying the proceeds to the amount due on the note, with interest.

(b) The sections of Commercial Law involved are those dealing with the statute of limitations, and with the law of bailments, particularly the rights of pledgor and pledgee.

(c) Action on the note itself, of course, is barred by the statute of limitations, since the statute on a demand note starts to run from the date of the note (sec. 98). However, the right to liquidate the debt by sale of the securities pledged is not barred by the statute. (See sec. 101, subd. (c).) It is a gen-

⁴*In re Denison's Estate*, 157 Misc. 385, 284 N.Y. Supp. 705, 707.

eral rule, subject to at least one exception,⁵ "that a creditor may hold and realize on collaterals pledged or deposited to secure a debt although action on the principal obligation is barred by limitation."⁶

1870. NY Apr. 1943 (2). (a) In connection with negotiable instruments, what is the meaning of *protest*?

(b) Is protest required by law in case of the dishonor of a bill of exchange drawn in New York City and payable in (1) Philadelphia, Pennsylvania, (2) Liverpool, England, (3) Rochester, New York, (4) San Juan, Puerto Rico?

(a) *Protest* is formal attestation of the dishonor of a negotiable instrument. The word is often loosely used to mean taking the necessary steps to charge secondary parties (drawers and indorsers) with liability in case an instrument has been dishonored by nonacceptance or by nonpayment. Technically, however, a certificate of protest is a formal statement by a notary public, attested by his seal, or by a respectable resident of the place of dishonor in the presence of two or more witnesses, to the effect that presentment of a specific instrument was duly made at a given time and place to a given person, and payment or acceptance demanded and refused. *Notice of protest* is notice given by a notary to parties secondarily liable, of the fact that the instrument in question was duly presented, dishonored and protested.

(b) Protest is not required by law except in the case of foreign bills of exchange. A domestic or inland bill of exchange is one drawn and payable in the same state; all others are foreign (sec. 281). Hence, in the instances given, protest is required in connection with the dishonored bills of exchange payable in Philadelphia, Liverpool, and San Juan, but not in connection with the bill payable in Rochester.

1871. NY Oct. 1942 (11). (a) Upon receipt of purchased stocks, what details of the certificates should the purchaser examine?

(b) What is necessary to make good delivery of certificates sold?

(c) In what ways may the owner of stocks which were purchased for him at different times and held by his broker make sure that for a sale of a part of the shares delivery is made from specific purchases?

(a) On receipt of purchased stocks, the purchaser should

⁵ The California statute provides that the lien of a pledge is extinguished by lapse of time within which action can be brought on the obligation secured by the pledge.

⁶ 53 *Corpus Juris Secundum* 932, citing numerous cases in various states.

examine the certificate to make sure that it is in proper form, and that it correctly evidences the shares of stock purchased. Thus, as to form, it should bear a recent date and a serial number, it should be duly signed and countersigned by officers of the corporation, and it should bear the corporate seal (usually in the lower left hand corner). Where the stock is in a large corporation, or is traded on an exchange, it is customary to provide for countersignature by a transfer agent or registrar. Such countersignature usually serves as an assurance that the certificate is properly signed, because it is the duty of the transfer agent, before countersigning, to make sure that the certificate has been properly signed.

The purchaser should also make sure that the certificate bears the proper number, description, and classification of shares (such as 500 shares of First Preferred, or of Class E, or whatever the correct description or class of the stock may be), and that the purchaser's name is correctly inscribed in the certificate.

(b) Good delivery of shares of stock is delivery personally, by registered mail, or otherwise, as called for by contract or by custom governing such delivery, of a duly executed certificate, with proper evidence of transfer of title, either by indorsement on the back of the certificate or by execution of a stock power (in either case by the party named in the certificate), with guaranty of indorsement or stock power, in a proper case, by an exchange member firm.

(c) The answer to this question involves accounting or auditing techniques rather than principles of commercial law. The owner of stocks which were purchased for him and held by his broker may relate specific shares actually delivered to specific shares actually purchased and held on his behalf, by requiring a written statement from the broker which would disclose certificate numbers of shares purchased for the owner, numbers of shares represented by each of such certificates, dates of purchase and certificate dates, and any other data which would identify each and every purchase of the shares in question by certificates representing the blocks purchased.

1872. NY Apr. 1941 (5). (a) Has a stockbroker, in order to recover advances made by him, the right to sell stock bought by him for the account of his customer on margin?

(b) If so, under what terms and conditions may he sell the stock?

(a) A stockbroker may sell stock bought by him for the account of his customer on margin, under the terms and conditions specified in *b* below.

(b) When a stockbroker buys stock for a customer and carries it for him on margin, it is impliedly agreed, in the absence of express provision to the contrary, that if the stock depreciates, the "margin" shall be replenished and kept good upon demand, and upon failure to do so, that the stock may be sold upon reasonable and customary notice. (See sec. 586.)

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1917	June	682	243	682	133	134	194	197	205	194	214	682	T	450	451	450 ¹
	Nov.	212	195	202	213	677	677	246	127	131	682	453	450	682	370	T ²
1918	May	195	201	194	195	209	202	135	136	136	139	244	447	458	447	456 ³
	Nov.	(See Footnote 4)														
1919	May	205	214	211	214	132	477	249	454	446	361	362	T	T	x	x
	Nov.	203	211	214	206	139	124	684	447	454	676	679	368	T	T	T
1920	May	215	199	206	124	137	246	455	459	448	368	361	678	680	T	T
	Nov.	196	203	204	202	123	132	452	446	369	366	679	T	x	x	x
1921	May	195	203	684	200	243	124	246	370	365	451	446	677	T	x	x
	Nov.	198	209	684	217	248	132	244	370	363	449	452	677	T	x	x
1922	May	685	213	209	209	685	247	135	363	691	457	685	685	T	x	x
	Nov.	199	202	212	206	138	246	247	365	364	454	452	676	681	T	x
1923	May	199	214	208	200	131	135	129	360	369	446	458	460	T	T	x
	Nov.	210	215	200	202	131	132	139	367	368	452	457	678	T	x	x
1924	May	199	196	213	200	124	127	127	363	362	686	457	679	T	T	x
	Nov.	208	213	204	686	248	131	139	212	361	686	686	686	T	T	x
1925	May	206	205	212	686	132	130	248	370	363	451	451	685	T	T	x
	Nov.	(See Footnote 5)														
1926	May	208	194	209	217	687	687	453	132	132	687	365	365	680	T	x
	Nov.	126	367	282	T	200	133	458	281	201	T	455	364	134	199	T
1927	May	123	247	124	139	196	198	202	203	459	687	361	362	T	T	x
	Nov.	205	208	207	213	281	135	139	451	448	362	365	680	T	T	x
1928	May	688	216	216	201	125	137	124	688	458	366	367	T	T	x	x
	Nov.	123	202	T	688	209	134	508	243	211	T	677	450	129	x	x
1929	May	454	206	138	T	197	361	448	126	208	283	T	53	688	139	x
	Nov.	688	361	T	454	194	281	195	680	212	T	T	247	324	x	x

¹ Question No. 16 is on p. 459.

² Question No. 16 was a Tax question.

³ Question No. 16 is on p. 455; No. 17 on p. 369; No. 18 was a Tax question.

⁴ The November 1918 examination classified the questions by subject, with separate numbers thereunder. Question No. 1 under Contracts appears on p. 683; No. 2 on p. 128; No. 3 on p. 124; No. 4 on p. 243; and No. 5 on p. 126. Question No. 1 on Negotiable Instruments appears on p. 208; No. 2 on p. 208; No. 3 on p. 194; No. 4 on p. 683; and No. 5 on p. 206. Question No. 1 on Corporations appears on p. 458; No. 2 on p. 458; No. 3 on p. 683; and No. 4 on p. 454. Question No. 1 on Partnership appears on p. 361 and No. 2 on p. 362. In addition, there were two Federal Tax questions.

⁵ The November 1925 examination was given in two parts. Part I, Question No. 1 appears on p. 130; No. 2 on p. 198; No. 3 on p. 362; No. 4 on p. 135; No. 5 on p. 681; No. 6 on p. 446; No. 7 on p. 129; No. 8 on p. 203; No. 9 on p. 369; and No. 10 on p. 215. Part II, Question No. 1 appears on p. 682; No. 2 on p. 677; No. 3 on p. 131; No. 4 on p. 446; No. 5 on p. 194; No. 6 on p. 130; No. 7 on p. 365; No. 8 on p. 686; No. 9 on p. 686; No. 10 on p. 686; and No. 11 on p. 282. Part II, No. 12 was a Tax question.

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1930	May	200	246	365	T	452	676	244	244	204	T	368	643	T	x	x
	Nov.	509	322	194	454	369	128	213	125	138	131	447	T	x	x	x
1931	May	455	213	126	452	583	510	133	363	245	641	544	T	x	x	x
	Nov.	134	324	608	249	367	459	509	249	203	677	642	T	x	x	x
1932	May	689	137	245	211	370	282	132	478	283	583	689	T	x	x	x
	Nov.	128	204	509	545	448	324	138	199	367	127	447	T	x	x	x
1933	May	128	203	249	209	323	246	214	477	457	511	281	T	x	x	x
	Nov.	211	582	243	53	123	196	125	125	565	690	126	T	x	x	x
1934	May	135	690	455	681	478	137	459	212	52	690	691	T	x	x	x
	Nov.	201	641	459	360	324	130	544	211	52	130	246	564	x	x	x
1935	May	719	976	770	854	835	768	845	723	887	892	1006	797	x	x	x
	Nov.	729	901	714	739	1017	710	763	995	915	695	925	810	x	x	x
1936	May	700	884	712	849	779	868	714	932	769	981	1014	870	x	x	x
	Nov.	953	883	729	695	931	735	826	759	877	853	888	722	x	x	x
1937	May	737	818	857	748	861	790	928	918	766	911	T	712	x	x	x
	Nov.	710	846	755	787	714	940	818	859	879	1000	983	992	x	x	x
1938	May	723	913	736	771	710	896	791	884	775	902	T	T	x	x	x
	Nov.	775	841	905	712	711	1013	749	832	928	741	T	T	x	x	x
1939	May	734	867	827	764	836	954	903	781	1000	973	911	963	x	x	x
	Nov.	827	750	892	856	711	769	902	736	699	912	718	1016	x	x	x
1940	May	821	866	761	721	843	T	1010	828	775	905	977	762	x	x	x
	Nov.	1020	862	748	720	798	957	830	906	714	939	978	741	x	x	x
1941	May	895	706	1030	786	922	812	741	782	906	834	890	946	x	x	x
	Nov.	715	725	825	746	880	848	764	727	782	895	926	912	x	x	x
1942	May	713	823	840	881	707	787	1004	957	748	1026	974	921	x	x	x
	Nov.	952	982	794	967	695	T	717	726	762	832	807	945	x	x	x
1943	May	962	916	894	1013	745	743	859	990	T	781	750	700	x	x	x
	Nov.	824	728	866	757	T	946	1002	778	920	794	858	T	x	x	x
1944	May	829	734	758	T	861	855	1024	789	810	916	1007	936	x	x	x
	Nov.	T	763	726	926	901	T	979	950	966	839	776	833	x	x	x
1945	May	767	783	892	819	T	802	989	852	709	960	914	1012	x	x	x
	Nov.	871	804	761	716	816	998	784	849	808	919	T	752	x	x	x

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1916	Jan.	677	679	678	679	545	138	679	137	509	208	283	460	364	207	564
	June	681	477	446	543	509	204	244	508	607	214	362	544	582	582	453
1917	Jan.	446	477	681	53	325	511	510	545	449	T	368	457	325	478	282
	June	53	682	53	544	545	545	T	682	52	52	194	682	200	682	446
1918	Jan.	132	682	214	682	246	682	582	370	281	682	216	641	682	477	682
	June	683	683	683	139	283	642	683	683	582	364	136	321	683	545	360
1919	Jan.	139	282	322	508	640	564	683	216	136	135	683	544	583	478	455
	June	641	322	321	509	249	683	216	683	211	210	244	683	53	449	607
1920	Jan.	478	325	509	509	135	362	366	684	684	323	544	640	282	684	136
	June	446	682	684	201	363	451	322	683	135	T	478	680	681	214	477
1921	Jan.	136	325	478	684	365	213	216	215	684	215	456	453	282	642	684
	June	134	368	564	282	511	217	460	53	129	282	449	320	449	684	642
1922	Jan.	608	201	325	684	607	201	685	683	132	544	T	T	243	243	685
	June	210	608	678	200	453	321	201	54	685	129	508	685	211	685	215
1923	Jan.	207	678	685	323	608	243	203	53	212	607	607	609	452	508	510
	June	139	363	455	362	211	460	T	137	564	545	685	455	642	217	216
1924	Jan.	456	641	197	54	207	136	360	53	52	607	641	322	362	684	282
	June	139	139	139	283	322	362	135	196	678	608	322	686	686	460	52
1925	Jan.	640	282	368	684	216	365	607	685	608	686	449	607	452	322	214
	May	640	202	449	446	200	686	607	642	510	583	453	325	214	133	446
1926	Jan.	369	281	544	453	686	642	686	203	687	687	607	640	T	687	52
	May	687	54	132	323	324	459	456	676	677	582	206	212	641	280	687
	Nov.	687	682	454	687	320	582	194	203	280	364	367	370	123	509	127
1927	May	544	687	321	687	362	321	361	687	607	607	687	450	688	688	194
	Nov.	688	363	688	205	688	133	687	281	324	679	321	452	368	206	247
1928	May	688	366	449	199	564	607	688	680	369	688	366	244	477	451	198
	Nov.	609	366	321	458	544	681	283	211	281	200	133	217	127	450	680
1929	May	203	582	688	137	688	456	681	206	608	453	136	197	247	365	207
	Nov.	678	132	243	202	280	676	582	52	362	544	215	210	136	607	321
1930	May	688	363	688	199	564	607	687	214	324	688	366	452	206	451	198
	Nov.	688	200	583	53	920	450	689	232	208	T	T	T	323	215	447

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1931	May	689	689	T	130	247	129	200	194	477	246	281	283	T	322	246
	Nov.	689	689	366	245	T	133	T	125	689	321	508	200	324	243	130
1932	June	689	280	323	689	360	T	689	544	202	139	458	510	643	124	T
	Nov.	689	243	841	455	677	543	691	321	689	205	689	456	198	133	134
1933	Apr.	689	690	366	246	217	201	545	53	641	135	477	280	53	280	135
	Oct.	131	321	545	581	T	640	690	680	52	690	641	454	459	210	248
1934	Apr.	126	362	608	607	T	204	136	321	690	446	680	280	215	477	447
	Nov.	691	T	243	682	360	477	564	544	321	544	200	52	457	691	459
1935	Apr.	799	760	753	970	722	930	1007	793	951	844	780	805	939	943	731
	Oct.	738	789	761	925	900	715	723	835	852	865	973	988	953	1007	T
1936	Apr.	820	1017	924	850	882	885	959	977	986	911	703	994	749	941	934
	Oct.	728	827	852	862	794	788	755	920	865	1001	918	735	1013	892	712
1937	Apr.	979	752	703	933	719	1018	1028	993	943	972	830	T	T	961	872
	Oct.	826	708	896	760	841	1007	806	702	955	920	942	800	782	T	T
1938	Apr.	870	836	T	708	754	743	1003	1009	1016	795	819	697	T	698	889
	Oct.	827	730	891	981	908	952	974	1008	971	863	947	796	732	703	800
1939	Apr.	987	747	838	788	T	T	1030	1014	865	923	718	964	813	1010	889
	Oct.	838	887	900	721	751	800	831	935	951	984	T	970	944	T	798
1940	Apr.	854	1006	909	725	875	743	962	1023	785	811	T	863	987	923	1019
	Oct.	870	932	777	822	717	733	698	760	969	780	981	1011	1031	705	938
1941	Apr.	772	811	950	975	1034	822	717	880	697	701	909	759	854	792	995
	Oct.	797	878	1024	937	T	821	1004	737	996	921	1032	841	945	778	997
1942	Apr.	744	1011	985	932	859	910	1026	963	786	949	938	T	747	810	722
	Oct.	823	774	705	T	701	795	898	947	973	822	1033	954	847	1001	758
1943	Apr.	831	1033	954	779	968	984	910	877	1005	999	809	936	732	837	927
	Oct.	695	847	773	816	869	1009	737	784	701	1020	985	756	918	1022	699
1944	Apr.	882	923	765	812	965	744	706	696	863	904	825	992	x	x	x
	Nov.	T	763	726	926	901	T	979	950	966	839	776	833	x	x	x
1945	May	767	783	892	819	T	802	989	852	709	960	914	1012	x	x	x
	Nov.	871	804	761	716	816	998	784	849	808	919	T	752	x	x	x

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